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32nd Midwest/Midsouth Estate Planning Institute

Office of Continuing Legal Education at the University of Kentucky College of Law

UK CLE

32nd ANNUAL

MIDWEST/MIDSOUTH ESTATE PLANNING INSTITUTE

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OFFICE OF CONTINUING LEGAL EDUCATION
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TABLE OF CONTENTS

2004-2005 NOTABLE DEVELOPMENTS OF INTEREST TO ESTATE PLANNERS

Turney P. Berry
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SECTION A

2004-2005 NOTABLE DEVELOPMENTS OF INTEREST TO ESTATE PLANNERS

2004-2005 NOTABLE DEVELOPMENTS OF INTEREST

TO ESTATE PLANNERS

A. INCOME TAX MATTERS

1. **Death Benefit Under Deferred Annuity Contract Is IRD**. Rev. Rul. 2005-30, 2005-20 IRB 1, dealt with a situation where an owner-annuitant purchased a deferred annuity contract and died before the annuity starting date. In question were the income tax effects of payments from the annuity. Rev. Rul. 79-335 provides that amounts received by a beneficiary under a deferred annuity contract that exceeded the owner's investment in the contract were included in the beneficiary's income under section 72(e). The contract was ineligible for a basis step-up under section 1014 (see 1014(b)(9)(A)). Because the annuitant would have income had the contract been surrendered during the owner's life, the IRS determined that the amounts were IRD. PLR 200041018 had reached a similar result.

2. **Exclusion of Gain from Sale of Principal Residence**. Final regulations have been issued under section 121 dealing with the exclusion of gain from the sale of a principal residence. T.D. 9152. Section 121(c) allows taxpayers who do not meet the usual test for exclusion of $250,000 or $500,000 of capital gains on the sale of a principal residence - - use as a residence for two of the preceding five years and no gain exclusion on a sale within the last two years - - to exclude some gain. In general, in order to make use of the special rule of section 121(c) a taxpayer must have sold the residence on account of a change in place of employment (general rule: the new workplace must be 50 miles further from the residence than the old workplace), a health issue (change of residence is to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury of the taxpayer owner), or unforeseen circumstances (death, divorce, multiple births, condemnation are among the things which the IRS lists as unexpected; marriage and adoption the IRS thinks are foreseeable). The regulations elaborate on these and create various safe-harbors.

3. **Consequences of Policy Loans**. In Revolinski et. al. v. Commissioner, T.C. Summ. Op. 2005-26 (2005) (unpublished), the Tax Court held that a taxpayer's withdrawals of funds from a universal life policy were loans and when the policy was surrendered he received a taxable distribution in an amount calculated by taking the accumulated value of the policy and subtracting his investment in the policy. In determining the accumulated value the amount of the loans was included., as was interest on the amount.

4. **Grantor and Grantor Trust May Not Form Partnership Alone**. Rev. Rul. 2004-77, 2004-31 IRB 119, sets forth that a partnership may not be formed between a person and an entity which is disregarded as to that person.

B. CHARITABLE AND TAX-EXEMPT MATTERS - Sections 170, 642, 664, 501, 509, 2055, 2522, and 4940-4947

1. **Making Changes to a Charitable Remainder Trust**. In PLR 200441019 the IRS gave effect to a state court reformation of a charitable remainder unitrust. The trust was drafted with a 7% payout but should have been a 5% payout. The unitrust recipient returned the extra cash which had been distributed to the trust. The reformation and repayment was not self-dealing. In PLR 200502037 a CRUT was divided incident to a divorce. As part of that division the grantor renounced the power to revoke the spouse's interest in the trust and charity remained the trustee and beneficiary of each trust.

2. **Assignment of Income Issues ("Palmer Problems")**. In PLR 200230004 husband and wife proposed to transfer 495 of 500 shares of a C corporation to a charitable remainder unitrust and asked whether the redemption by the corporation would be self-dealing. The ruling determined it would not be self-dealing because there is an exception to the self-dealing rules:

> Section 53.4941(d)-3(d)(1) of the foundation regulations provides that, in general, under section 4941(d)(2)(F), any transaction between a private foundation and a corporation which is a disqualified person will not be an act of self-dealing if such transaction is engaged in pursuant to a liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization, or reorganization, so long as all the securities of the same class as that held (prior to such transaction) by the foundation are subject to the same terms and such terms provide for receipt by the foundation of no less than fair market value. For purposes of this paragraph, all of the securities are not subject to the same terms unless, pursuant to such transaction, the corporation makes a bona fide offer on a uniform basis to the foundation and every other person who holds such securities.

The taxpayers also asked whether the C corporation dividends would be unrelated taxable income and the answer was no, even though the corporation would be a controlled corporation, because dividends are excepted:

> Section 512(b)(13)(A) of the Code provides that notwithstanding section 512(b)(1), (2), and (3), an organization (controlling organization) receiving a specified payment from another entity which it controls (controlled entity), shall include such payment as an item of gross income derived from an unrelated trade or business to the extent such payment reduces the net unrelated income of the controlled entity (or increases any net unrelated loss of the controlled entity). There shall be allowed all deductions of the controlling organization directly connected with amounts treated as derived from an unrelated trade or business under the preceding sentence.
>
> Section 512(b)(13)(C) of the Code provides that the term "specified payment" means any interest, annuity, royalty, or rent.
>
> Section 512(b)(13)(D)(i) of the Code provides, in part, that the term "control" means in the case of a corporation, ownership (by vote or value) of more than 50 percent of the stock of such corporation, and in any other case (other than a

> corporation or a partnership) ownership of more than 50 percent of the beneficial interests in the entity.
>
> The modifications contained in section 512(b) of the Code, in effect, constitute an exception to the general rule by excluding from the computation of unrelated business taxable income items such as dividends, interest, annuities, royalties, and rents. If these modifications, which are provided in section 512(b)(1), (2), and (3), are considered an exception to the general rule of taxing the unrelated business income of exempt organizations, then section 512(b)(13) may be considered an exception to the exception. Under section 512(b)(13), the exclusion of interest, annuities, royalties, and rents provided by section 512(b)(1), (2), and (3) does not apply where such amounts are derived from "controlled organizations."
>
> The exception to the modifications contained in section 512(b) of the Code is not applicable in this case. Although Trust, which holds the majority of X stock, is a "controlling organization" within the meaning of section 512(b)(13), the income earned by X while part of its stock is owned by Trust will not constitute UBTI to Trust. The distributions to Trust from X while Trust owns part of its stock are dividends. The receipt of dividends is not taxable to Trust, because section 512(b)(1) excludes dividends from the UBTI, and the rules of section 512(b)(13) do not apply to the payment of dividends.
>
> Therefore, the income earned by X while part of its stock is owned by Trust will not constitute unrelated business taxable income to Trust. In addition, distributions to Trust from X while Trust owns part of its stock will constitute dividends that are excluded from unrelated business income under section 512(b)(1) of the Code, so long as they are not interest, annuities, royalties, and rents derived from the controlled corporation.

Finally, the taxpayers asked whether the redemption would be treated as an assignment of income. The ruling states:

> This request involves Palmer v. Commissioner, 62 T.C. 684 (1974), affd. on other grounds, 523 F.2d 1308 (8th Cir. 1975), acq., 1978-1 C.B. 2. In the Palmer case, the Tax Court held that a taxpayer's gift of stock in a closely held corporation to a private foundation, followed by a redemption, was not to be recharacterized as a sale or redemption between the taxpayer and the corporation followed by a gift of the redemption proceeds to the foundation, even though the taxpayer held voting control over both the corporation and the foundation. The Tax Court based its opinion, in part, on the fact that the foundation was not legally obligated to redeem the stock at the time it received title to the shares.
>
> In Rev. Rul. 78-197, 1978-1 C.B. 83, the Internal Revenue Service announced that it will treat the proceeds of a redemption of stock under facts similar to those in the Palmer case as income to the donor only if the donee is legally bound or can be compelled by the corporation to surrender the shares for redemption.
>
> In the present case, at the time X shares are transferred to Trust, X will be under no legal obligation to redeem the contributed stock. There is no agreement among the parties under which X would be obligated to redeem, or Trust would be obligated to surrender for redemption, the stock. Trust is not legally obligated

> to accept any offer of redemption made by X. Accordingly, any redemption by X of the stock contributed by Grantors to Trust will be respected.
>
> Based on the representations submitted and information described above, we conclude that a purchase by X of the stock transferred by Grantors to Trust will be treated as a redemption of the stock from Trust, and will not be treated as a redemption of stock from Grantors or a distribution by X to Grantors. Therefore, the sale or redemption by Trust of its X stock will not result in the capital gain in such sale or the redemption price being attributed for tax purposes to Grantors.

Among the representations made – whether required or given voluntarily – was:

> In addition, A, as president and sole shareholder of X and grantor and co-trustee of Trust, represents the following:
>
> (1) I, A, grantor and co-trustee of Trust, hereby represent that neither I nor any family member of me will acquire, offer to acquire, or become obligated to acquire shares of X stock from Trust earlier than at least one year after the date of any transfer of shares of X stock to Trust.
>
> (2) I, A, President and sole shareholder of X, hereby represent that X will not redeem, offer to redeem, or become obligated to redeem shares of X stock from Trust earlier than at least one year after the date of any transfer of shares of X stock to Trust, directly or indirectly, by the grantor of Trust or a family member of the grantor.
>
> (3) I, A, President and sole shareholder of X, and grantor and co-trustee of Trust, hereby represent that neither X nor I am aware of any plan or intention of Trust to transfer any corporate stock, or to have any person acquire any corporate stock from Trust.

The application of Revenue Ruling 78-197 arose in Gerald A. Rauenhorst, et ux. v. Commissioner, 119 T.C. No. 9 (2002). Arbeit (a partnership) owned warrants enabling it to purchase NMG stock. On September 28, 1993, WCP (a corporation) offered to purchase all NMG stock. On November 9, 1993 the partnership assigned come warrants to four charities. On November 19 sold its remaining warrant to WCP, and the charities sold their warrants to WCP. On November 22, 1993, WCP and NMG agreed on a sale of all the NMG stock.

The government argued that the bright-line rule of Rev. Rul. 78-197 was not controlling. The Opinion states:

> Respondent argues that petitioners are not entitled to judgment as a matter of law and that genuine issues of material fact remain for trial. Respondent argues that the question whether the donees were bound or could be legally compelled to surrender their NMG warrants is not "the critical issue" to be resolved and, accordingly, neither Carrington v. Commissioner, supra, nor Rev. Rul. 78-197, supra, controls this case. It is respondent's position that "the critical issue" in this case is "a factual one": whether petitioners' rights to receive the proceeds of the stock transaction involving WCP "ripened to a practical certainty" at the time of the assignments. Respondent relies on Ferguson v. Commissioner, 174 F.3d 997 (9th Cir. 1999), Jones v. United States, supra, Kinsey v. Commissioner, 477 F.2d

> 1058 (2d Cir. 1973), affg. 58 T.C. 259 (1972), Hudspeth v. United States, 471 F.2d 275 (8th Cir. 1972), and Estate of Applestein v. Commissioner, supra.
>
> Respondent purports to distinguish both Carrington and Rev. Rul. 78-197, supra, on the facts of the case and the ruling. To that end, he contends that Carrington and Rev. Rul. 78-197, supra, are not inconsistent with the cases he relies upon above. Respondent claims that in this case, and the cases upon which he relies, there was a pending "global" transaction for the purchase and sale of all the stock of a corporation at the time of the gift or transfer at issue. He then surmises that because Carrington and Rev. Rul. 78-197, supra, did not involve a pending "global" transaction, the legal principles of those authorities do not apply. Instead, he argues that we must apply the principles of the cases he relies upon, and, accordingly, we must conduct a detailed factual inquiry for purposes of determining whether the sale of the stock warrants had ripened to a practical certainty at the time of the assignments.
>
> We cannot agree that respondent has effectively distinguished Carrington and Rev. Rul. 78-197, supra, on their facts. First, neither this Court nor the Courts of Appeals have adopted respondent's theory of a pending "global" transaction as a means of distinguishing cases such as Carrington and Palmer v. Commissioner, 62 T.C. 684 (1974). Indeed, the case law in this area applies essentially the same anticipatory assignment of income principles to cases of a "global" nature as those applicable to cases of a "nonglobal" nature. See, e.g., Greene v. United States, supra at 581. We can only interpret respondent's use of the phrase "pending global transaction" as simply a restatement of the principles contained in the cases upon which he relies. Thus, we cannot agree that respondent's reliance on a pending global transaction distinguishes either Carrington, Rev. Rul. 78-197, supra, or other cases upon which petitioners rely. With that being said and leaving Carrington and those other cases aside at this point, the bright-line test of Rev. Rul. 78-197, supra, which focuses solely on the donee's control over the contributed property, stands in stark contrast to the legal test and the cases upon which respondent relies and which consider the donee's control to be only a factor.

The Court took a dim view of the government's urging that Rev. Rul. 78-197 be ignored:

> While this Court may not be bound by the Commissioner's revenue rulings, and in the appropriate case we could disregard a ruling or rulings as inconsistent with our interpretation of the law, see Stark v. Commissioner, 86 T.C. 243, 251 (1986), in this case it is respondent who argues against the principles stated in his ruling and in favor of our previous pronouncements on this issue. The Commissioner's revenue ruling has been in existence for nearly 25 years, and it has not been revoked or modified. No doubt taxpayers have referred to that ruling in planning their charitable contributions, and, indeed, petitioners submit that they relied upon that ruling in planning the charitable contributions at issue. Under the circumstances of this case, we treat the Commissioner's position in Rev. Rul. 78-197, 1978-1 C.B. 83, as a concession. Accordingly, our decision is limited to the question whether the charitable donees were legally obligated or could be compelled to sell the stock warrants at the time of the assignments.

On the facts, the court found in favor of the taxpayer:

Petitioners argue that as of November 12, 1993, the date the warrants were transferred on the books of NMG, the donees had not entered into any agreement to sell the warrants and could not be compelled by any legal means to transfer the warrants. Accordingly, they contend that, as a matter of law, there was not an assignment of income. Petitioners submitted affidavits from representatives of the donees in support of their motion for partial summary judgment. Each of those affidavits outlines the events which preceded the assignments, each states that the stock warrants were received on November 12, 1993, and each also states that, as of that date, the donees had not entered into agreements to sell the stock warrants.

Respondent questioned the reliability of those affidavits, and he contended that the affidavits were deficient in that they failed to state the personal involvement of the representatives with respect to petitioners' contributions. He also asserted that the testimony of those affiants is "unknown", and he questioned whether they were involved in any negotiations or discussions with NMG, WCP, or Arbeit regarding WCP's proposed acquisition of NMG stock and warrants. Respondent also questioned the affiants' competency "to opine upon, or reach any conclusion as to, what constitutes a binding agreement or whether their respective organizations had indeed entered binding agreements in connection with the transactions at issue." We do not share respondent's reservations with respect to the affidavits, and we find those affidavits credible.

First, in response to respondent's allegations, petitioners submitted additional affidavits from each of the affiants. Each of those affidavits states: (1) The affiants were personally involved with respect to petitioners' contributions; (2) before the donees' execution of the warrant purchase and sale agreement, there were no agreements amongst the donees, Arbeit, Mr. Rauenhorst, or any other person or entity regarding the sale of the warrants; and (3) through November 12, 1993, there were no negotiations or communications between the donees and NMG or parties representing NMG, except for the letters from NMG's legal counsel requesting that the donees sign an Additional Party Signature Page.

Second, respondent relies on nonspecific allegations of an informal agreement or understanding between the donees and NMG, WCP, Mr. Rauenhorst, and/or Arbeit. Summary assertions and conclusory allegations are simply not enough evidence to raise a genuine issue of material fact. [citations omitted]

Respondent alleges no facts or evidence to substantiate his position, and he has submitted no affidavits in response to the affidavits that petitioners submitted. Instead, he points out that the record lacks information regarding any discussions, deliberations, or negotiations which may have taken place between the donees and the other parties. Respondent has had ample opportunity to investigate the facts surrounding these transactions, and it is clear that respondent could have requested additional information from the individuals involved. See Rule 121(e). He has requested neither additional discovery nor a continuance for purposes of additional discovery. He has not demonstrated to our satisfaction that the only available method for opposing the statements in the affidavits is through cross- examination at trial. Further, it is insufficient for the opposing party to argue in the abstract that the legal theory involved in the case encompasses factual questions. <u>Hibernia Natl. Bank v. Carner</u>, 997 F.2d 94, 98 (5th Cir. 1993); <u>Daniels v. Commissioner</u>, supra. Since petitioners have offered affidavits directly supporting their position on a material issue of fact, and since respondent has failed to counter those affidavits with anything other than unsupported allegations, respondent cannot avoid summary judgment on this

> issue. See Greene v. United States, 806 F. Supp. 1165, 1171 (S.D.N.Y. 1992), affd. 13 F.3d 577 (2d Cir. 1994). Thus, we find that there is no genuine issue of material fact regarding whether the donees entered into a legally binding agreement to sell their stock warrants before, or at the time of, the assignments by petitioners.

Footnote 14 states:

> The record indicates that no agreement was entered into by the donees before Nov. 19, 1993, the date they signed the warrant purchase and sale agreement. On Nov. 16, 1993, NMG's legal counsel sent letters to each of the donees enclosing a warrant purchase and sale agreement. Those letters state that pursuant to the warrant purchase and sale agreement, the donees would agree to sell their reissued warrants to WCP and "to abstain from either exercising its Warrant or selling or otherwise transferring it to any other party through Dec. 31, 1993." Certainly, the formality of having the donees enter into the warrant purchase and sale agreements suggests that they had not entered into any binding agreements before Nov. 19, 1993.

Subsequent to the decision, the government has reiterated its intention, generally, to follow its own rulings in litigation.

In PLR 200321010 a retired officer of a corporation intended to give shares of the corporation to a CRUT. The corporation had the right to purchase the stock if it so desired, and the agreement also bound the trust:

> X proposes to establish a CRUT (as defined in § 664 of the Internal Revenue Code). Upon establishment of the CRUT, X will notify Company of X's intent to transfer a portion of X's Company stock purchased under the Plan to the CRUT, thereby triggering Company's option to purchase the stock for the formula price set forth in the stock restriction agreements applicable to such stock. Taxpayer represents that Company will likely decline to purchase the stock for the formula price set forth in the stock restriction agreements and thus X will be free to transfer the stock to the CRUT. The stock transferred to the CRUT will continue to be subject to the terms of the stock restriction agreements under the Plan in accordance with the terms of the stock restriction agreements. Therefore, if the trustee of the CRUT wishes to sell or otherwise dispose of the stock, Company will have a right to purchase the stock for the formula price set forth in the stock restriction agreements. The trustee will notify Company that the CRUT wishes to sell Company stock prior to any proposed sale or disposition. X represents that Company has always exercised its option under the stock restriction agreements in the past for the formula price set forth therein.

The ruling described the "bright-line" test of Palmer, citing Rauenhorst:

> The Service has acquiesced in the Palmer decision. See 1978-1 C.B. 2. In Rev. Rul. 78-197, 1978-1 C.B. 83, the Service concluded that it will treat the proceeds of a redemption of stock under facts similar to those in Palmer as income to the donor only if the donee is legally bound or can be compelled by the corporation to surrender the shares for redemption. The Tax Court has characterized the "legally bound" standard in Rev. Rul. 78-197 as a "bright line" test for determining if a contribution of stock to a charity followed by a

> redemption of that stock from that charity should be respected in form or recharacterized as a redemption of the stock from the donor followed by a contribution of the proceeds by the donor to the charity. See generally, Rauenhorst v. Commissioner, 119 T.C. No. 9 (October 7, 2002).

Thus, the ruling concludes:

> Consequently, the test for purposes of this ruling request, is whether the CRUT will be legally bound or can be compelled by Company to surrender the stock for redemption at the time of the donation. Here, X proposes to transfer the Company stock to the CRUT. Under the restrictions contained in each year's stock restriction agreement, the CRUT must first offer the stock to Company at a set formula price should the CRUT propose to dispose of the shares. This provision amounts to a right of first refusal. However, it does not mean that the CRUT is legally bound or can be compelled by Company to surrender the stock to Company at the time of the donation. The information submitted contains no indication that the CRUT will be legally bound, or could be compelled by Company, to redeem or sell the gifted stock. That all or a portion of the gifted stock was subject to restrictions upon transfer to a third party by X, and thus by the CRUT following the transfer, does not give Company the ability to compel its redemption or sale from the CRUT. The CRUT is free to retain title to and ownership of the stock indefinitely.
>
> Because the CRUT is not legally bound and cannot be compelled by Company to redeem or sell the stock, we conclude that the transfer of the Company stock by X to the CRUT, followed by any subsequent redemption of the stock by Company, will not be recharacterized for federal income tax purposes as a redemption of the stock by Company from X followed by a contribution of the redemption proceeds to the CRUT. See Palmer v. Commissioner, supra, and Rev. Rul. 78-197, supra. The same principles apply if the stock is sold by the CRUT rather than redeemed by Company. Thus, provided there is no prearranged sale contract whereby the CRUT is legally bound to sell the stock upon the contribution, we conclude that any subsequent sale will not be recharacterized for federal income tax purposes as a sale of the stock by X, followed by a contribution of the sale proceeds to the CRUT. Accordingly, any redemption proceeds or sales proceeds received by the CRUT for the stock will not be treated as taxable income received by X.

3. **Flexible Deferred Gift Annuities**. In PLR 200449033 the donor contributed assets to a charity in exchange for the charity paying an annuity to the donor for life beginning at a date to be specified in the future. The donor may elect a starting date during an eight year period and the annuity amount will be calculated then with the annuity agreement specifying the rates payable as of various dates. Presumably in valuing the charitable gift the charity and donor must assume that an annuity having the highest possible value will be paid.

4. **Bequest of Art**. PLR 200418002 deals with a bequest of art to a museum will qualify for a section 2055 charitable deduction. The bequest would be subject to extensive requirements of the museum. The ruling summarizes the agreement:

> The Taxpayers entered into an Agreement on Date 1 with Foundation and the Trustees of Museum concerning the Taxpayers' donation of the Collection either

during the lifetime of either or both of them or upon the death of the survivor of them (Donation). The Agreement was later amended on Date 2 and Date 3.

Section 1.A of the Agreement provides that in the event the Taxpayers elect, in their sole discretion, to make the Donation, the Trustees of Museum shall accept the Collection on behalf of the Museum, and the Trustees shall display and maintain the Collection in accordance with the terms and conditions set forth herein. Immediately upon the occurrence of the Donation, title to the Collection shall vest in the Trustees, for the benefit of Museum, and at all times thereafter the Trustees shall be and remain solely responsible for the custody, control, management, exhibition, conservation of and curatorial services for, the Collection in accordance with the terms of this Agreement. Trustees acknowledge and agree that nothing contained in this Agreement shall be deemed to obligate the Taxpayers to make the Donation.

Section 2.A (i) provides that the intention of the parties is that each work of art comprising the Collection shall at all times be located, housed and permanently displayed, in perpetuity, at either the Museum or Donors' Gallery. The Museum shall at all times utilize the Donors' Gallery to its capacity for the exhibition of works of art from the Collection, or the exhibition of works of art by artists whose works comprise part of the Collection which are either part of the Museum's collection, or on loan to the Museum, or exhibited in connection with special temporary exhibitions. At all times, a minimum number of works of art from the entire Collection shall be housed and permanently displayed, in perpetuity, at the Museum. The minimum number is defined as a number not less than the total number of gifts of works of art made by the Taxpayers prior to the Donation, excluding works on paper. In accordance with the provisions of the Agreement, if after utilizing the Donors' Gallery to its capacity and adhering to the provisions of paragraph 2.A.(i) in the Agreement with respect to the Minimum Number, there remain works of art in the Collection not on display, the Museum will use its best efforts to exhibit such works of art at the Museum.

Section 2.A (ii) provides that all works of art on paper comprising part of the Collection shall at all times be located, housed and/or displayed at the Donors' Gallery, consistent with generally accepted conservation guidelines in effect from time to time. Such works of art on paper shall be subject to temporary relocation to the Museum for the sole purpose of exhibiting such works of art on paper at the Museum, or in connection with research.

Section 2.B provides that upon the Donation, the Trustees of Museum shall promptly cause all works of art in the Collection to be included within the Museum's blanket insurance policy, which insures the Museum's entire collection from time to time. The proceeds of any such insurance shall, at the option of the Trustees, be used either for the restoration of the damaged work, or the purchase of a replacement work of art by any of the artists whose works of art comprise the Collection.

Section 2.C provides that the Museum will provide all conservation and curatorial services for each work of art in the Collection, wherever located, in the same manner as is provided for the Museum's permanent collection, at the sole cost and expense of Museum. The conservation and curatorial services for the Collection shall include, but shall not be limited to, all cleaning, framing, hanging, handling, restoration, transportation, and insurance. In the event that any work of art in the Collection requires restoration, the Museum shall select a restorer who is an expert in the school of art and/or artist of the work involved, whether or not that restorer is employed by Museum.

Section 2.D provides that all of the works in the Collection which are displayed at the Museum will be displayed in galleries which have been decorated, equipped, and maintained in a manner which, in the professional judgment of the Director or Chief Curator of Museum, will enhance the aesthetic appeal of the works in the Collection, will provide for the comfortable enjoyment of the Collection by the public, and will be comparable in quality and aesthetic appeal to the permanent collection currently displayed at the Museum. The Museum will be solely responsible for all reasonable costs and expenses relating to the decoration, equipping and maintenance of the galleries at the Museum in which the Collection is displayed, which will include the responsibility for all lighting, air conditioning and humidity controls, cleaning, installation, security systems, security, seating and floor coverings in the galleries. In addition, the galleries in which the Collection is displayed shall be in locations which are at all times during Museum hours easily accessible to the public.

Section 2.E provides that the Museum shall be responsible for all conservation and curatorial services for each work of art from the Collection located at the Donors' Gallery, including all cleaning, framing, hanging, handling, restoration, transportation, and insurance, and all costs and expenses related thereto. The Trustees shall select an administrator of the Donor's Gallery who shall coordinate the respective duties and activities of the Trustees and the Board, and act as liaison between them. The Trustees shall have the right to change the Administrator from time to time in their sole discretion. The Administrator shall be responsible for the administration and operation of the Donors' Gallery and the Taxpayers' residence, including, but not limited to, all lighting, air conditioning and humidity controls, cleaning (other that the works of art in the Collection), security systems, security, seating and floor coverings; and all of the expenses in connection with the foregoing, including the salary of the Administrator, shall be borne by the Foundation.

Section 2.F provides that each work of art in the Collection, as well as the entire Collection, wherever located, will at all times be attributed, clearly and visibly, as part of the Collection.

Section 2.G provides that the Trustees of Museum shall not, at any time, sell, trade, transfer or otherwise dispose of, or permit the sale, trade, transfer or other disposition of, all or any of the works of art in the Collection. In the event of any attempted sale, trade, transfer or disposition of any work of art in the Collection in violation of the terms of this Agreement, the ownership of that work of art shall immediately and automatically vest in the Foundation, without any action on the part of the Foundation.

Section 2.H provides that subject to the provisions of paragraph 2.A hereof, the Trustees shall not, at any time, store, loan or relocate, or permit the storage, lending or relocation, of any of the works of art in the Collection (other than the relocation of works of art in the Collection between the Donors' Gallery and the Museum), except under special circumstances approved by the Museum's senior staff Member(s) of Period art, such as a major retrospective or in order to enhance the reputation of a particular artist or artists in connection with an exhibition of the works of such artist or artists.

Section 2.I provides that the Trustees agree to display works of art at the Donors' Gallery at all times of sufficient quantity, quality and variety so as to establish the high standards established by Taxpayers. Accordingly, in the event that the Trustees remove any works of art which are part of the Collection from the Donors' Gallery for the purpose of exhibiting such works of art at the Museum, or for any reason permitted under the provisions of this Agreement, the Trustees shall, in place of the works of art so removed, exhibit works of art which are not part of the Collection, provided that such works of art are by artists whose works of art are part of the Collection.

Section 2.J provides that the Museum will promote the use of Donors' Gallery so as to make the public aware of the quality of the Collection and the setting in which the Collection is displayed, all to the end that the Collection shall become open and accessible to, and stimulate the interest of, the general public.

Section 3 provides that prior to or simultaneously with the Donation, the Taxpayers will contribute to the Foundation the Donors' Gallery, the Taxpayers' residence, and funds to generate an income stream which will, in the opinion of the Taxpayers, be sufficient to operate the Foundation, operate and maintain the Donors' Gallery and the Taxpayers' residence, and otherwise comply with the Foundation's other obligations under this Agreement.

Section 6 provides that in the event that Museum defaults in its obligations, the Foundation shall have the option, upon written notice to the Trustees, to terminate the Agreement, and/or to exercise any other remedies available to them at law or in equity. Upon termination of the Agreement, the ownership of all of the works of art comprising the Collection which have been given or donated to the Trustees for the benefit of Museum shall immediately revert to the Foundation.

Section 7.A provides that the Foundation shall operate the Donors' Gallery for a minimum of ten years from the date of the Donation. At any time after the expiration of such ten year period, the Foundation shall have the right to terminate this Agreement, upon thirty days written notice to the Trustees, in the event that: (i) the Collection is on permanent display at the Museum; (ii) in the opinion of the Foundation, it is not economically feasible to continue to operate and maintain the Donors' Gallery and the Taxpayers' residence; or (iii) in the opinion of the Foundation, the continued operation of the Donors' Gallery and the Taxpayers' residence is not consistent with the intent of the Taxpayers.

Section 7.B provides that in the event that the Foundation elects to terminate this Agreement in accordance with the provisions set forth in Paragraph A, the Trustees shall promptly cause any portion of the Collection remaining at the Donors' Gallery to be delivered to the Museum, which delivery shall be fully insured, all at the cost and expense of the Museum. After termination of this Agreement, neither the Trustees nor the Museum shall have any claim to any assets of the Foundation.

Section 7.C provides that in the event that the Foundation terminates this Agreement in accordance with the provisions of Paragraph A above, or in the event that the Foundation has not terminated this Agreement and there is a material diminution of the gallery space at the Donors' Gallery for other than a temporary period of time, the Trustees shall thereafter use their best efforts to

> locate, house and display the entire Collection at the Museum in accordance with the provisions of Paragraph 2.A.

The ruling concludes favorably:

> In the present case, under the terms of both Husband's and Wife's will, the works of art comprising the Collection will pass to the Museum upon the death of the survivor of the Taxpayers. Museum is an organization described in section 501(c)(3). If the Museum does not accept the Collection, then the Collection will pass to the Foundation, an organization described in section 501(c)(3). Under the Agreement, Museum may not sell any of the Collection and may loan art in the Collection under specially defined circumstances. Further, under the Agreement, if Museum defaults on its obligation, the Collection reverts to the Foundation. Under no circumstances will the Collection revert to the Taxpayers or inure to the benefit of other private individuals. Accordingly, based upon the facts submitted and the representations made, we conclude that:
>
> > 1. The value of the proposed bequest upon the death of the survivor of Taxpayers to the Museum (or if the Museum refuses to accept the contribution, to the Foundation), of the Taxpayer's interest in the works of art comprising the Collection, subject to the conditions of the Agreement, will be deductible from the Taxpayer's gross estate under section 2055.
> >
> > 2. The amount of the deduction under section 2055 for the proposed bequest, upon the death of the survivor of the Taxpayers, to the Museum (or if the Museum refuses to accept the contribution, to the Foundation), of the Taxpayer's interest in the works of art comprising the Collection, will be equal to the full fair market value of the Taxpayer's interest in the works of art comprising the Collection includible in the Taxpayer's gross estate under sections 2031 and 2033.

5. **Charitable Split-Dollar Income Tax Deduction**. In Addis v. Commissioner, 374 F.3d 881 (9th Cir. 2004) the court affirmed the Tax Court's disallowance of an income tax deduction in a charitable split-dollar arrangement, on the grounds that the charity improperly represented that it had provided no goods or services to the taxpayer insured. See also Weiner v. Commissioner, 102 Fed. Appx. 631 (9th Cir. 2004), and David C. Roark v. Commissioner, T. C. Memo 2004-271, for similar decisions.

6. **Termination of Charitable Remainder Unitrust**. Another ruling approving the early termination of charitable remainder trust is PLR 200441024. There is no self-dealing but the entire amount received by the settlor of the trust is long-term capital gain.

7. **Effect of Spousal Election on Charitable Remainder Trusts**. Under the law of certain states, a spouse's elective share may be satisfied using assets set aside in inter vivos transfers, such as a charitable remainder trust. This is the "augmented estate" approach of the Uniform Probate Code. Under section 664(d) the ability of assets in a charitable remainder trust to be paid to another (e.g. an electing spouse) causes the trust to fail to qualify as a charitable remainder trust. To minimize this problem, in Rev. Proc. 2005-24, 2005-16, IRB 1, the IRS created a safe-harbor allowing a spouse to waive the right of election with respect to charitable remainder trust assets. The waiver must be in writing, signed and dated by the spouse and delivered to the trustee. The waiver need not waive any other rights of the spouse to other property or to the annuity or unitrust payments from the trust.

The waiver must be executed within six months after the due date (including extensions) of Form 5227 (Split-Interest Trusts) for the year in which the LATER of the following occurs: (1) the trust is created, (2) the donor marries the spouse, (3) the donor becomes subject to a jurisdiction giving rise to the right of election, or (4) the effective date of a new state law in the state of applicable jurisdiction which creates the right of election.

The waiver will be required for all charitable remainder trusts created on or after June 28,2005. For trusts created previously, the right of waiver will be ignored unless the surviving spouse does make the election.

The Rev. Proc. requires that the waiver be valid under applicable state law.

8. <u>Donor's Investment Control</u>`. In PLR 200445023 and PLR 200445024 the IRS outlined the rather substantial control a donor may retain over funds contributed to a charity. The charity was a college. One donor was an individual and the other was a limited liability company. The agreement between the donors and the college specifically stated that the donated assets were the sole property of the college and any act of self-dealing was prohibited. Nonetheless. the donor, or the donor's investment manager, retained investment authority over the assets subject only to a stated investment policy. The IRS concluded that income and gift tax deductions were allowed for the donated assets.

9. <u>Private Foundation Rules</u>. In PLR 200448049 the IRS determined that a Delaware corporation which owns a limited liability company which in turn owns various interests in private equity investment funds would not be treated as a business subject to the excess business holdings limits of section 4943; instead the limits would be subject to the limits.

In PLR 200432026 a private foundation obtained a private letter ruling regarding various unrelated business income issues. The Foundation's payment of the costs of obtaining the ruling, even though it also involved other taxpayers and disqualified persons, was not self-dealing.

10. <u>Changes Made by the American Jobs Creation Act of 2004</u>. Three significant changes were made to the charitable contribution rules by the last tax act. First, for contributions of property other than cash, marketable securities, inventory, and vehicles, any gift of more than $5000 must be substantiated with a qualified appraisal or the deduction is denied. The appraisal must be attached to the return if the donation exceeds $500,000. Second, for vehicles - - cars, boats, airplanes - - the donee must provide contemporaneous acknowledgment containing the vehicle identification number and the charity must also certify the terms on which it was either used or sold, and, if sold, the gross proceeds. The amount of the charitable deduction cannot exceed the gross proceeds. Third, for intellectual property, a deduction is allowed at the time of contribution only for the lesser of basis or fair market value but subsequent deductions are allowed calculated on the basis of the amount earned by the charity over the next 12 years., beginning with a deduction equal to 100% of the income earned in the first two years declining to 10% in the last two years. The donor and donee have various reporting requirements as well.

11. **Charitable Remainder Trust Distribution Ordering Rules**. On March 16, 2005 the IRS issued final regulations on the section 664(b) ordering rules for characterizing charitable remainder trust distributions. T. D. 9190. The regulations are effective as of March 16, 2005.The regulations require the income of a CRT be assigned, in the year it must be taken into account by the CRT, to one of three categories: ordinary income, capital gains, and other income. Within a category, items of income are tracked separately based on the income tax rate applicable to the type of income. Distributions from a CRT are deemed to carry out first ordinary income, then capital gains, and then other income, and within a category, first to carry out the class of income in the highest income tax bracket, then the next, and so on through the lowest bracket. Within the capital gains category, long-term gains and losses are netted before netting against short-term gains and losses. The determination of categories and classes of income is made at the end of the CRT tax year. The recipient of a distribution from a CRT pays income tax at the rates in effect in the year of distribution not the year in which the CRT received the income. These same ordering rules apply even for a year in which the trust is not tax-exempt.

C. SECTION 408 — IRAs AND RETIREMENT PLANS

1. **Posthumous IRA Rollover**. In PLR 200415011 an unmarried taxpayer died after taking an IRA distribution and the executor, the decedent's son and a beneficiary, repaid the IRA. The IRS determined that the distribution was taxable. On the other hand, in PLR 200415012 permitted a surviving spouse to do a post-death rollover more than 60 days after the decedent withdrew funds from an IRA, granting her a hardship waiver under Rev. Proc. 2003-16.

2. **Roll-Over of Statutory Share**. In PLR 200438045 the IRS allowed a surviving spouse who took half of an IRA as part of her statutory share to execute a spousal roll-over.

3. **Liberal 60 Day Roll-Over Ruling Position**. The IRS appears to have adopted a very liberal ruling policy with respect to the 60 day IRA roll-over provisions. In general, the IRS appears to allow almost any mistake to be corrected so long as basic intent to roll-over is shown and the funds distributed to the taxpayer were not spent for personal expenses or living expenses. See Thomas Murphy, "IRs Rulings on IRA Rollovers Have Now Been Liberalized," 32 Estate Planning 4 (April 2005) at pages 36 - 39 for a summary of various rulings.

4. **Disclaimers Make Spouse Designated Beneficiary**. In PLR 200505030 decedent, a state employee, had designated an inter vivos trust as beneficiary of a Salaried Employees Retirement System plan and a Deferred Compensation Plan. Subsequently the decedent created a second trust which received the residue of his estate, and provided trusts for his wife after death, and destroyed the first as part of his estate planning. The state plans provided that if there were no designated beneficiary a decedent's estate would be the beneficiary.

The beneficiaries of the trusts disclaimed, and then the intestate takers disclaimed such that, eventually, surviving spouse became the sole beneficiary. The IRS allowed the decedent's wife to roll over the distributions into her IRA.

5. **IRAs in Bankruptcy**. In Rousey v. Jacoway, 544 U.S. ____, 125 S. Ct. 1561 (2005) the Supreme Court held that the assets in a rollover IRA could not be reached by the creditors of the IRA owner who had filed for bankruptcy. In Patterson v. Shumate, 504 U.S. 753 (1992) the Court held that many qualified plans were exempt from claims in bankruptcy and this holding was an extension of that one. Here, the Court did not specifically deal with non-rollover IRAs. Regardless, the benefits of the decision are limited. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 changes the Bankruptcy Code to limit the amount of an IRA which is exempt from claims to $1,000,000 on top of any amount attributed to roll-overs from qualified plans.

D. SECTIONS 671-678 -- GRANTOR TRUST RULES.

1. **Non-Grantor, Non-Gift Trust Created** PLR 200148028 is very helpful. The taxpayer established a trust that is not a grantor trust but gifts to which are incomplete. The facts were:

> Grantor proposes to establish an irrevocable Trust which will be funded by intervivos and testamentary transfers. The Trust provides for one trustee (Trustee) and two members of a Distribution Committee. Article 1.1 provides that during the lifetime of the Grantor ("Initial Term"), the Trustee shall have no power or authority to make any distribution of net income or principal of the trust estate, to, or for the benefit of, any trust beneficiary at any time when any person is serving as a member of the Distribution Committee unless the distribution is made at the direction of the Distribution Committee. Distributions may be made to the Grantor, the Grantor's Spouse or any of the descendants of the Grantor's parents.
>
> Article 3.6 provides that the initial members of the Distribution Committee shall be the two eldest adult and competent persons eligible to receive distributions out of the Trust estate (other than the Grantor or the Grantor's spouse). At all times during the Grantor's life, the Distribution Committee shall be comprised of two persons, then eligible to receive distributions out of the Trust estate (other than the Grantor or the Grantor's spouse). During the Initial Term, the Distribution Committee shall direct the Trustee with regard to (i) all discretionary distributions from the Trust estate to beneficiaries, and (ii) certain of the Trustee's powers. The Trustee is authorized and directed to follow the direction of the Distribution Committee. All rights and powers conferred on the Distribution Committee shall be exercisable only by unanimous action of all members of the Distribution Committee except that any member of the Distribution Committee acting alone may direct the Trustee to make one or more distributions upon obtaining the Grantor's prior written consent to each such distribution and filing such consent with the Trustee.
>
> The Trust lasts during the lifetime of the Grantor. Under Article 1.2, upon the death of the Grantor, income and principal of the Trust estate, as it is then constituted shall be transferred, conveyed and paid over to such person or persons then eligible to receive distributions out of the Trust estate, other than

> the Grantor, as the Grantor appoints by the Grantor's will. To the extent all, or any portion of the income and principal of the Trust estate is not so effectively appointed, such income and principal shall be divided into a sufficient number of equal shares so that there shall be set aside one such share for each child of the Grantor who is then living, and one such share for the collective descendants who are then living of any child of the Grantor who is not then living. From each such share so set aside for the collective descendants who are then living of any child of the Grantor who is not then living there shall be set aside per stirpital parts for such descendants. If no descendant of the Grantor is living at the death of the Grantor, the income and principal of the Trust, to the extent not effectively appointed, shall be distributed, free from Trust, to the then living descendants per stirpes, of the Grantor's parents.
>
> Article 1.3 provides that the Grantor may, at any time during the Grantor's life release the Grantor's right to receive discretionary distributions of income and principal from the trust estate, the right to consent to distributions as described in Article 3.6, and/or the power of appointment described in Article 1.2, and may limit the persons or entities in whose favor the power of appointment described in Article 1.2 may be exercised. Article 1.3 further provides that notwithstanding any of the foregoing or any other provision of this Agreement, the Grantor shall have no power or authority to change the class of persons eligible to receive distributions during the Initial Term (except to cause the Grantor personally to be excluded from the class by releasing the Grantor's own right to be eligible to receive such distributions.)

With respect to why the trust would not be a grantor trust the ruling states:

> Because of the discretion of the Distribution Committee, acting together, or singly with the consent of the Grantor, to make distributions from income and/or corpus to one or more of the beneficiaries which includes the members of the Distribution Committee, the members of the Distribution Committee have a substantial beneficial interest in both the income and corpus portions of the Trust. Any distribution that the Grantor wishes to make from assets contributed to the Trust by that Grantor, could be made only if one of the members of the Distribution Committee agrees. Since each of the two Distribution Committee members is a potential recipient of Trust distributions, a consent to a distribution could adversely affect that individual's beneficial interest in the Trust. Thus, with respect to the Grantor, both of the members of the Distribution Committee are adverse parties within the meaning of section 672(a).
>
> The requirement in Article 3.6 that the initial members, and any current or successor member of the Distribution Committee shall be the two eldest adult and competent persons eligible to receive distributions out of the Trust estate and that at all times during the Grantor's life, the Distribution Committee shall be comprised of two persons, then eligible to receive distributions out of Trust estate, ensures that the Grantor will not be able to act independently of an adverse party. The restrictions on the powers of the Trustee preclude the Trustee from independently controlling distributions or making loans without the consent of an adverse party.
>
> The Grantor does not have a reversionary interest in excess of five percent in any portion of the Trust. Accordingly, section 673 does not apply to treat Grantor as owner of any portion of the Trust. Because control over the beneficial enjoyment of, and any distributions of, income and corpus is exercisable by the Grantor,

> only with the consent of a Distribution Committee member, who is an adverse party, Grantor will not be treated as the owner of any portion of the Trust under section 674 or section 677. The Trust agreement does not authorize any of the circumstances that cause administrative controls to be considered exercisable primarily for the benefit of the grantor under section 675. Section 676 does not apply to Grantor because Grantor cannot revest title in the Grantor in any portion of the Trust. Section 678 is not applicable since none of the trustees and no other person will have a power exercisable solely by that person to vest the corpus or income of the Trust in that person.

The existence of the grantor's special testamentary power of appointment prevented the gift from being complete until such time as distributions were made from the trust to someone other than the grantor.

In PLR 200247013 the taxpayer was arguably more aggressive. The class of beneficiaries was the descendants of the Taxpayer's parents, and two of the taxpayers siblings were the Distribution Committee.

This kind of trust will help grantors avoid state capital gains taxes on sales of assets.

See also PLR 200502014 for a similar ruling.

E. SECTION 1361 - S CORPORATIONS

1. **Life Tenant as Qualified Shareholder**. PLR 200404033 allowed a life estate to qualify as a Qualified Subchapter S Trust. The life tenant received all the income annually, could sell the shares and reinvest the proceeds, and could not dispose of the shares in a manner to defeat the remainderman's interest.

2. **Voting and Non-Voting Shares as One-Class of Stock**. PLR 200407006 confirms that voting and non-voting shares are one class of stock for S corporation purposes.

3. **Changes Made By the American Jobs Creation Act of 2004**. The new tax act makes various changes to the S corporation rules. Among the changes are: (a) the number of shareholders is increased from 75 to 100 and an election may be made to treat members of a family as one shareholder with a "family" being the lineal descendants of a common ancestor (and their spouses or former spouses) but the common ancestor may not be more than six generations removed from the youngest generation of shareholders at the time the S election is made; (b) in determining whether a trust may qualify as an ESBT, unexercised powers of appointment are ignored; (c) an ESBT has one year (rather than 60 days) to dispose of S corporation stock if an ineligible shareholder becomes a beneficiary; (d) when a Qualified Subchapter S Trust disposes of S stock the beneficiary may deduct suspended losses under the passive activity and at-risk rules; and (e) if losses have been suspended because they exceed a shareholder's basis and the shares are transferred incident to a divorce, the losses/deductions are shifted to the shareholder's spouse or former spouse.

F. SECTIONS 2031 and 2512 — VALUATION

1. **Subsequent Sales as Evidence of Value**. Helen Noble died on September 2, 1996 owning 116 of 1000 shares of Glenwood Bank. The other shares were held by Glenwood Bancorporation. The estate valued the shares at book value less a 45% minority interest discount for a total of just over $900,000. In October 1997 Glenwood Bancorporation bought the 116 shares for $1,100,000. At issue in Estate of Helen M. Noble v. Commissioner, T. C. Memo 2005-2, was of what significance was the subsequent sale in establishing the value of the shares.

The estate argued that two sales prior to death, of 10 shares and seven shares, were relevant but that a post-death sale was not relevant. The Tax Court disagreed and held that a post-death sale was the most relevant where it occurred 14 months after death. The opinion states:

> Petitioners conceded at trial that they bear the burden of proof in this case. They acknowledge that an arm's-length sale of property near the valuation date is the best indicium of its fair market value on the valuation date, but, they assert, only certain sales near a valuation date are "competent, substantial and persuasive evidence" of that fair market value. According to petitioners, sales may be probative of fair market value only if they occur within a reasonable time before the valuation date. Petitioners primarily support this position with a citation of *Douglas Hotel Co. v. Commissioner,* 190 F.2d 766, 772 (8th Cir. 1951), affg. 14 T.C. 1136 (1950). They also assert that a prior sale of property conclusively sets the fair market value of that property on a later valuation date even if the seller was not knowledgeable of all relevant facts as to that property and even if the property that was the subject of the sale was not of comparable size to the property subject to valuation. They recognize that a determination of fair market value on the basis of actual sales has often been said to include requirements that a seller be knowledgeable and that the seller's property be comparable to the property subject to valuation. They assert, however, that the Court of Appeals for the Ninth Circuit in *Morrissey v. Commissioner,* 243 F.3d 1145, 1149 (9th Cir. 2001), revg. *Estate of Kaufman v. Commissioner,* T.C. Memo. 1999-119, eroded these requirements to now make them irrelevant.
>
> We disagree with petitioners' assertion that the two prior sales of 10 shares and 7 shares, either separately or together, are an accurate measure of the applicable fair market value of decedent's 116 shares. In *Morrissey,* the Court of Appeals for the Ninth Circuit held that sales of 10,000 and 6,960 shares of stock on May 12 and June 16, 1994, respectively, at $29.70 per share, reflected the fair market value of 46,020 shares of that stock as of an earlier valuation date of April 14, 1994. The Court of Appeals stated that the sellers were under no compulsion to sell their shares and that they did so at the price that the buyer had represented was the price listed in a recent appraisal. The Court of Appeals stated that each seller testified at trial that the price was fair and that the sale had not been compelled.
>
> Contrary to petitioners' assertion, we read nothing in *Morrissey* to indicate that the Court of Appeals for the Ninth Circuit eroded the requirements that a seller of stock be knowledgeable and that the seller's shares be comparable in number to the shares subject to valuation in order for the sale to be probative of a valuation of the latter shares.[1] In fact, the Court of Appeals noted specifically as

to the knowledge requirement that both sellers had sold their stock at approximately the same price as listed in the appraisal and that both sellers were aware that dividends had been meager even in prosperous years. *Id.* at 1148. The Court of Appeals also indicated as to the comparable property requirement that the prior sales of stock were not unrepresentative of the stock subject to valuation. *Id.*

As to the two prior sales of stock in this case, we also are unpersuaded that either of those sales was made by a knowledgeable seller who was not compelled to sell or was made at arm's length. See *Estate of Fitts v. Commissioner,* 237 F.2d at 731 (taxpayer bears the burden of establishing that sales are made at arm's length and in the normal course of business). In addition, contrary to the factual setting of *Morrissey v. Commissioner, supra,* the two prior sellers in this case did not sell their stock for the amount set forth in an appraisal. They sold their stock for much less than the per-share value set forth in the later appraisal; the estate, in turn, sold its shares after the appraisal for more than the fair market value set forth therein. Moreover, the two respective prior sales represented 1 percent and .7 percent of Glenwood Bank's outstanding stock. Decedent's 116 shares, by contrast, represented 11.6 percent of that outstanding stock and were the only shares of Glenwood Bank stock not owned by the other shareholder. Mercer testified credibly that it was reasonably foreseeable as of the applicable valuation date that the other shareholder, Bancorporation, would eventually want to buy that 11.6-percent interest at some unknown time and that this added a special value to the interest. Our hypothetical seller would have known the same at the time of the hypothetical sale and as part of that hypothetical sale would have demanded compensation for this special value so as otherwise to not equate the selling price for the 10 shares and 7 shares with the hypothetical selling price of decedent's 116 shares.[2]

As to the third sale, which occurred on October 24, 1997, approximately 14 months after the applicable valuation date, we disagree with petitioners that only sales of stock that predate a valuation date may be used to determine fair market value as of that valuation date. The Court of Appeals for the Eighth Circuit, the court to which an appeal of this case most likely lies, has held specifically that "In determining the value of unlisted stocks, actual sales made in reasonable amounts at arm's length, in the normal course of business, within a reasonable time before or after the basic date, are the best criterion of market value." *Estate of Fitts v. Commissioner, supra* at 731; accord *Rubber Research, Inc. v. Commissioner,* 422 F.2d 1402, 1405- 1406 (8th Cir. 1970), affg. T.C. Memo. 1969-24; see also *Estate of Jung v. Commissioner,* 101 T.C. 412, 430-432 (1993); *Estate of Scanlan v. Commissioner,* T.C. Memo. 1996-331. Although petitioners observe correctly that the Court of Appeals for the Eighth Circuit stated in *Douglas Hotel Co. v. Commissioner,* 190 F.2d at 772, that "Evidence of what property sold for within a reasonable time before the material date upon which its fair value is to be determined is universally considered competent, substantial, and persuasive evidence of its fair value on the material date", this statement was made solely with respect to the evidentiary value of a sale that predated the date of valuation there. The Court of Appeals did not state as petitioners ask us to hold that only sales which occur before a valuation date are probative as to fair market value on the valuation date. In fact, the Court of Appeals went on to state specifically as to prior sales that "It is, of course, not the only evidence which may be considered on the subject" of valuation. *Id.;* accord *Polack v. Commissioner,* 366 F.3d at 612 ("subsequent events that shed light on what a willing buyer would have paid on the date in question are admissible, such as 'evidence of actual sales prices received for property after the

> date [in question], so long as the sale occurred within a reasonable time . . . and no intervening events drastically changed the value of the property.'" (quoting *First Natl. Bank v. United States,* 763 F.2d 891, 894 (7th Cir. 1985))); see also *Estate of Jung v. Commissioner, supra* at 431-432; *Estate of Scanlan v. Commissioner, supra.*
>
> Generally speaking, a valuation of property for Federal tax purposes is made as of the valuation date without regard to any event happening after that date. See *Ithaca Trust Co. v. United States,* 279 U.S. 151 (1929). An event occurring after a valuation date, however, is not necessarily irrelevant to a determination of fair market value as of that earlier date. An event occurring after a valuation date may affect the fair market value of property as of the valuation date if the event was reasonably foreseeable as of that earlier date. *First Natl. Bank v. United States, supra* at 894; *Bank One Corp. v. Commissioner,* 120 T.C. at 306. An event occurring after a valuation date, even if unforeseeable as of the valuation date, also may be probative of the earlier valuation to the extent that it is relevant to establishing the amount that a hypothetical willing buyer would have paid a hypothetical willing seller for the subject property as of the valuation date.[3] *Polack v. Commissioner, supra* at 612; *First Natl. Bank v. United States, supra* at 893-894; *Estate of Gilford v. Commissioner,* 88 T.C. 38, 52-54 (1987); *Estate of Jephson v. Commissioner,* 81 T.C. 999, 1002-1003 (1983); *Estate of Scanlan v. Commissioner, supra.* Unforeseeable subsequent events which fall within this latter category include evidence, such as we have here, "'of actual sales prices received for property after the date [in question], so long as the sale occurred within a reasonable time . . . and no intervening events drastically changed the value of the property.'" *Polack v. Commissioner, supra* at 612 (quoting *First Natl. Bank v. United States, supra* at 894); *First Natl. Bank v. United States, supra* at 893-894; see also *Estate of Jung v. Commissioner, supra* at 431-432; *Estate of Scanlan v. Commissioner, supra.*

The court did allow a 3% adjustment for inflation between the valuation date and sales date.

2. Discounting Assets For Built-In Income Taxes.

No discount was allowed in valuing retirement plans by the U.S. District Court in Estate of Louis R. Smith v. United States, 300 F. Supp. 2d 474 (S.D. Tex. 2004), aff'd 391 F.3d 621 (5th Cir. 2004). A willing buyer would not have income tax and thus under the hypothetical willing buyer - willing seller test there should be no discount said the court. That the estate and its beneficiaries would have IRD is not relevant because they are particular parties, not the hypothetical parties required by the test. Further, the IRD deduction under section 691(c) remedies any "fairness concerns" of the estate. See also In re: Neiderhiser, Pa. Commw. Ct., No. 1625 C.D. 2003 (May 14, 2004).

In Estate of Frazier Jelke III v. Commissioner, T. C. Memo 2005-131, the decedent's estate included 6.44% of a closely-held C corporation (CCC) the assets of which included $178,000,000 in marketable securities (out of a total value of $188,000,000) with $51,000,000 of built-in capital gains. The issue before the court was what discount should be allowed on account of eventual tax on the built-in gains. The court reviewed the state of the law:

> Since the repeal of the *General Utilities* doctrine, this Court has, on several occasions, considered the impact of built-in capital gain tax liability in valuing corporate shares. Our approach to adjusting value to account for built-in capital gain tax liability has varied and has often been modified or overruled on appeal. See, e.g., *Estate of Davis v. Commissioner,* 110 T.C. 530, 552-554 (1998); *Estate of Dunn v. Commissioner,* T.C. Memo. 2000-12, revd. 301 F. 3d 339 (5th Cir. 2002); *Estate of Jameson v. Commissioner,* T.C. Memo. 1999-43, revd. 267 F. 3d 366 (5th Cir. 2001); *Estate of Welch v. Commissioner,* T.C. Memo. 1998-167, revd. without published opinion 208 F. 3d 213 (6th Cir. 2000); *Eisenberg v. Commissioner,* T.C. Memo. 1997-483, revd. 155 F. 3d 50 (2d Cir. 1998); *Gray v. Commissioner,* T.C. Memo. 1997-67.
>
> In one case, we held that a discount for built-in capital gain tax liability was appropriate because even though corporate liquidation was unlikely, it was not likely the tax could be avoided. See Estate of Davis v. Commissioner, supra. However, this Court has not invariably held that discounts or reductions for built-in capital gain tax liability were appropriate where it had not been shown that it was likely the corporate property would be sold and/ or that the capital gain tax would be incurred. See, e.g., Estate of Welch v. Commissioner, supra; Eisenberg v. Commissioner, supra; Gray v. Commissioner, supra.
>
> Appellate courts in two of these cases reversed our decisions that a reduction in value for built-in capital gain tax liability was inappropriate. The Court of Appeals for the Second Circuit reasoned that, although realization of the tax may be deferred, a willing buyer would take some account of the built-in capital gain tax. Eisenberg v. Commissioner, 155 F. 3d at 57-58. Likewise, the Court of Appeals for the Sixth Circuit disagreed with our specific holding that the potential for a capital gain tax liability was too speculative. Estate of Welch v. Commissioner, supra. The Court of Appeals for the Sixth Circuit, to some extent, agreed with the Court of Appeals for the Second Circuit's approach in Eisenberg. Neither the Court of Appeals for the Second Circuit nor the Court of Appeals for the Sixth Circuit prescribed the amount of reduction or a method to calculate it.
>
> The Commissioner has since conceded the issue of whether a reduction for capital gain tax liability may be applied in valuing closely held stock by acquiescing to the Court of Appeals for the Second Circuit's decision in Eisenberg. See 1999-1 C.B. xix. In addition, in this case the parties agree and we hold that a reduction for built-in capital gain tax liability is appropriate. However, controversy continues with respect to valuing such a reduction. In two such cases involving the question of valuing reductions for built-in capital gain tax liabilities, the Court of Appeals for the Fifth Circuit has reversed our holdings. See Estate of Dunn v. Commissioner, supra; Estate of Jameson v. Commissioner, supra.

How should the discount be computed? The court agreed with Mr. Shaked, the IRS expert, stating:

> Having held that an assumption of complete liquidation on the valuation date does not apply in this case, we must consider the amount of the reduction to be allowed for the built-in capital gain tax liability. Respondent's expert began with the total amount of built-in capital gain tax liability ($ 51,626,884); and after determining when the tax would be incurred, he discounted the potential tax payments to account for time value principles. The estate attacks that approach by contending that CCC's securities will appreciate, increasing the future tax payments and thereby obviating the need to discount.

The estate's expert, in an effort to support this theory, testified that if the premise is that the liquidation or sale of substantially all of a corporation's assets would occur in the future, there should also be:

> a long term projection * * * that the stock will appreciate. If the stock appreciates, the capital gains tax liability will appreciate commensurate [sic]. The present value of the capital gains tax liability will be the same. Only if you assume there's no appreciation in the stock would you discount the capital gains tax. And that's a completely unreasonable assumption.

Thus, the estate through its expert, Mr. Frazier, contends that irrespective of the unlikelihood of liquidation there should be a dollar-for-dollar decrease for the built-in capital gain tax liability, representing the present value of that liability because the liability will increase over time. In that regard, the estate argues that Mr. Shaked incorrectly assumed that the stock would not appreciate.

In addressing this argument, Mr. Shaked explained that the need to discount the built-in capital gain tax liability is analogous to the need to discount carryforward losses because they cannot be used until years after the valuation year. Mr. Shaked's approach is to calculate the built-in capital gain tax liability by determining when it would likely be incurred. We agree with Mr. Shaked's approach of discounting the built-in capital gain tax liability to reflect that it will be incurred after the valuation date.

Because the tax liabilities are incurred when the securities are sold, they must be indexed or discounted to account for the time value of money. Thus, having found that a scenario of complete liquidation is inappropriate, it is inappropriate to reduce the value of CCC by the full amount of the built-in capital gain tax liability. See Estate of Davis v. Commissioner, 110 T.C. at 552-553.12 If we were to adopt the estate's reasoning and consider future appreciation to arrive at subsequent tax liability, we would be considering tax (that is not "built in") as of the valuation date. Such an approach would establish an artificial liability. The estate's approach, if used in valuing a market-valued security with a basis equal to its fair market value, would, in effect, predict its future appreciated value and tax liability and then reduce its current fair market value by the present value of a future tax liability.

In that same vein, the estate argues that the Government, in other valuation cases, has offered experts who computed the capital gain tax on the future appreciated value of assets and discounted the tax to a present value for purposes of valuing a corporation. In one of those cases, the Court was valuing a corporation that owned rental realty (shopping centers). Estate of Borgatello v. Commissioner, T.C. Memo. 2000-264. As part of a weighting of factors to arrive at a discount, the Commissioner's expert calculated the potential for appreciation in the real estate market and the amount of built-in capital gain tax liability. This Court, to some extent, relied on the expert's methodology in its holding on value. In the other case relied upon by the estate, although the Commissioner's expert advanced a similar analysis, this Court rejected that expert's approach as an unsubstantiated theory. Estate of Bailey v. Commissioner, T.C. Memo. 2002-152.

The guidance of the expert was rejected in one of the cases cited by petitioner and was part of a discounting approach to assist the finder of fact (Court) to

> decide upon a discounted value in the other case. Although the expert's guidance in the latter case was considered in reaching a factual finding, the expert's approach does not represent the ratio decidendi of the case. In our consideration of the value of the marketable securities in this case, we are not bound to follow the same approach used by an expert in other cases. More significantly we do not find that approach to be appropriate in this case. Therefore, we find that in valuing decedent's 6.44-percent interest, CCC's net asset value need not be reduced by the entire \$51,626,884 potential for built-in capital gain tax liability and that future appreciation of stock need not be considered. We find Mr. Shaked's use of a 13.2-percent discount rate to be reasonable.13 In addition, the turnover rate of securities used by Mr. Shaked is conservative and reasonable under the circumstances. The asset turnover rate reasonably predicts the period over which the company's assets will be disposed of and thus built-in capital gain tax liability would likely be incurred. Consequently, we find it appropriate to use a 16-year period of recognition for the tax liability attributable to the built-in capital gain. We therefore accept Mr. Shaked's computation arriving at a \$3,226,680.25 annual tax liability and a discounted total liability of \$21,082,226.

The court also determined a 10% lack of control discount and a 15% lack of marketability discount for a total combined discount of 23.5%. Looked at as whole, the 6.44% interest in CCC, with no reductions, was worth \$12,148,000; the Tax Court value was \$8,255,000.

3. Lottery Payments. Valuation of a stream of lottery payments continues to generation litigation. In Estate of Paul C. Gubauskas v. Commissioner, 342 F. 3d 85 (2003), the Second Circuit reversed the Tax Court and held that lottery winnings in an estate should not be valued using section 7520. The Ninth Circuit held the same in Shackleford v. U.S., 262 F.3d 1028 (2001). On the other hand, the Fifth Circuit applied section 7520 in Cook v. Commissioner, 349 F.3d 850 (2003). So, there is a split among the Circuits which may lead to Supreme Court review (imagine!). Meanwhile, a U. S. District Court in Massachusetts followed Cook in Estate of John R. Donovan, Jr. v. United States, 95 A.F.T.R.2d 2005-2131(D. Mass. 2005).

4. Closely-Held Stock. Josephine Thompson died on May 2, 1998 a New York resident. Here executors were New York residents as well and a substantial asset in her estate was 20.57% of a New York closely-held company, TPC. TPC published business directories. The executors hired an Alaskan lawyer to appraise the decedent's interest in the business apparently in hopes of having the IRS Alaska office audit the return (to that end, the appraiser was also given limited administrative authority in the estate). The lawyer hired an accountant to help him and they valued the estate's TPK interest at \$1,700,000. The IRS hired an expert who arrived at a higher value, about \$32,388,000.

In Estate of Josephine T. Thompson, et. al. v. Commissioner, T. C. Memo 2004-174, the court considered the appropriate value and determined it was about \$13,500,000. The court allowed a 15% minority interest discount and a 30% lack of marketability discount in its determination. It would be fair to say that the court was not impressed with either expert.

Whether the estate should be subjected to a underpayment penalty was also at issue. Section 6662 applies a 40% penalty where the value reported is less than 25% of the value finally determined. Section 6664 provides an exception if the estate shows reasonable cause for the understatement and that it acted in good faith. An appraisal is an indication of good faith under the regulations. The opinion states:

> The valuation herein of the estate's 20-percent stock interest in TPC was particularly difficult and unique. Companies comparable to TPC were not found. Valuation of the estate's 20-percent TPC stock interest under the capitalization of income and under the discounted cashflow methods involved a number of difficult judgment calls. We believe it noteworthy and relevant to the appropriateness of the section 6662 penalty that even respondent's expert made significant errors in his various calculations.
>
> Complicating the valuation presented to the parties and to the Court herein was the difficult question as to how the Internet and the risks and opportunities associated therewith should be regarded as affecting TPC. The evaluation in this case of such intangible risks and opportunities was difficult and imprecise.
>
> Certainly, the experts for the estate were aggressive in their relatively low valuation of TPC. Respondent's expert was aggressive in his relatively high valuation of TPC. We note that our valuation of TPC and of the estate's 20-percent interest in TPC is closer to the estate's valuation than to respondent's valuation.
>
> On the record before us, we believe it inappropriate to impose the accuracy-related penalty. The estate is not liable for the accuracy-related penalty.

G. SECTION 2032 — ALTERNATE VALUATION AND SECTION 2032A — SPECIAL USE VALUATION

1. Manner and Time of Election of Alternate Valuation. Final regulations have been issued changing Treas. Reg. § 20.2032-1(b). T. D. 9172. The regulations state:

> (b) Method and effect of election -- (1) In general. The election to use the alternate valuation method is made on the return of tax imposed by section 2001. For purposes of this paragraph (b), the term return of tax imposed by section 2001 means the last estate tax return filed by the executor on or before the due date of the return (including extensions of time to file actually granted) or, if a timely return is not filed, the first estate tax return filed by the executor after the due date, provided the return is filed no later than 1 year after the due date (including extensions of time to file actually granted). Once the election is made, it is irrevocable, provided that an election may be revoked on a subsequent return filed on or before the due date of the return (including extensions of time to file actually granted). The election may be made only if it will decrease both the value of the gross estate and the sum (reduced by allowable credits) of the estate tax and the generation-skipping transfer tax payable by reason of the decedent's death with respect to the property includible in the decedent's gross estate. If the election is made, the alternate valuation method applies to all property included in the gross estate and cannot be applied to only a portion of the property.

The proposed regulations allow a protective election, which is helpful:

> (2) Protective election. If, based on the return of tax as filed, use of the alternate valuation method would not result in a decrease in both the value of the gross estate and the sum (reduced by allowable credits) of the estate tax and the generation-skipping transfer tax liability payable by reason of the decedent's death with respect to the property includible in the decedent's gross estate, a protective election may be made to use the alternate valuation method if it is subsequently determined that such a decrease would occur. A protective election is made on the return of tax imposed by section 2001. The protective election is irrevocable as of the due date of the return (including extensions of time actually granted). The protective election becomes effective on the date on which it is determined that use of the alternate valuation method would result in a decrease in both the value of the gross estate and in the sum (reduced by allowable credits) of the estate tax and generation- skipping transfer tax liability payable by reason of the decedent's death with respect to the property includible in the decedent's gross estate.

2. Combining Partnership Discounts and Section 2032A. In PLR 200448006 the decedent died owning general and limited partnership interests in a farm business. The interests passed as part of the residue of the decedent's estate to a trust for the benefit of decedent's children and grandchildren. The estate valued the partnership interests applying minority and lack of marketability discounts and then reduced the value as allowed under section 2032A. The IRS approved this method.

H. SECTION 2033 -----GROSS ESTATE

1. Reciprocal Trusts. PLR 200426008 is fascinating. Husband and Wife created parallel Crummey trusts and need to ensure they were not reciprocal. In most respects the trusts were identical. The IRS determined the trusts were not reciprocal and described the differences between the trusts as follows:

> In the present case, Husband's Trust differs from Wife's Trust in several respects. Husband's Trust grants Wife the right to withdraw specified amounts of trust principal after Son1's death. Husband's Trust also grants Wife an *inter vivos* special power, effective at Son1's death, to appoint trust principal among any of Husband's issue and their spouses or any trust created primarily for the benefit of one or more of those persons. Further, to the extent Wife does not exercise her *inter vivos* special power, Husband's Trust grants Wife an *inter vivos* or testamentary special power, effective at Son1's death, to appoint trust principal among any of Husband's issue and any charities Wife designates or any trust created primarily for the benefit of one or more of those persons. Finally, if a Marital Trust is established, Husband's Trust grants Wife a testamentary special power to appoint the assets remaining in the Marital Trust among any of Husband's issue and any charities Wife designates or any trust created primarily for the benefit of one or more of those persons.
>
> Under Wife's Trust, with respect to any trust established under Wife's Trust except a Marital Trust, Husband cannot be a beneficiary until three years after Wife's death and then will only be a beneficiary at any time when his net worth is under $a and his income from personal services is under $a. Distributions to Husband under this provision are limited to an amount equal to $b reduced by

Husband's income from personal services during the calendar year of the distribution.

I. SECTIONS 2035-2038 — RETAINED INTERESTS

1. **Application of Section 2036 to Family Limited Partnerships**. The IRS has attempted to minimize or eliminate the discounts claimed by taxpayers through family limited partnerships with various arguments, some based on general tax principles like the step-transaction doctrine and others more specifically Code based, typically sections 2703 and 2704. None of these arguments have been proven winners for the government. In fact, to date, most of the instances in which taxpayers have had difficulty have been when the form of the partnership was not respected by those involved. Stated another way, mistakes by the taxpayer and the taxpayer's family have generated about as many wins for the government as the government has earned on its own.

That line of cases is represented by Estate of Morton B. Harper v. Commissioner, T.C. Memo. 2002-121, The decedent, Mr. Harper, and his children, Michael and Lynn, formed a limited partnership using the assets in Mr. Harper's living trust. The particular facts recited by the court are important:

> At a time not entirely clear from the record, decedent made the decision to form a limited partnership and to contribute thereto the majority of his assets. An Agreement of Limited Partnership for Harper Financial Company, L. P. (HFLP), was prepared and sets forth the governing provisions for the entity. The document begins with language stating that the Agreement was made "as of the 1st day of January, 1994", but later recites that the partnership shall commence its existence upon the date a certificate of limited partnership is duly filed with the California Secretary of State.
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> * * *
>
> Michael and Lynn were named as the general partners of HFLP and the Trust as the sole limited partner, with interests of .4 percent, .6 percent, and 99 percent, respectively. Michael was also designated to serve as the managing general partner.
>
> * * *
>
> Although "the Portfolio" is not defined in the Agreement, there appears to be no dispute between the parties that it consisted of: (1) Securities held in a brokerage account at M. L. Stern & Co., Inc., (2) securities held in a Putnam Investments account, (3) securities held in two Franklin Fund accounts, (4) 2,500 shares of Rockefeller Center Properties, Inc., and (5) a $450,000 note receivable from Jack P. Marsh. The parties value these assets at between $1.6 and $1.7 million (rounded), an amount representing approximately 94 percent of decedent's total assets. The Trust's capital account in HFLP was credited with 99 percent of the value of the property contributed. Decedent retained, personally or through the Trust, his personal effects, a checking account, an automobile, and his Palm Springs condominium.
>
> * * *

The Agreement was signed by decedent on behalf of the Trust, by Michael, and by Lynn. Although the signatures are undated, the document was executed by Michael in May or June of 1994. Lynn could not remember when she signed the Agreement and did not read it prior to signing. A certificate of limited partnership was filed on behalf of HFLP with the California Secretary of State on June 14, 1994.

From June 17 to June 20, 1994, decedent was hospitalized in Palm Springs. Medical records prepared at that time contain the explanation set forth below:

> This is one of multiple Desert Hospital admissions for this 85-year-old Caucasian who is well known to have metastatic colonic carcinoma and prostatic carcinoma and admitted at the present time for poor oral intake, poor fluid intake, dehydration and for further rehydration, close observation, nutrition support, etc.

After his release, decedent went to Oregon, where he resided until his death. He first stayed with Michael for approximately a month and then moved into a nearby Oregon retirement facility known as Carmen Oaks. Carmen Oaks served independent individuals and was not a nursing center.

Thereafter, by a document entitled Assignment of Partnership Interest and Amendment No. 1 to Agreement of Limited Partnership for Harper Financial Company, L. P., dated and made effective as of July 1, 1994, the Trust transferred to Michael and Lynn 60 percent of the Trust's partnership interest. As a result, Michael and Lynn became holders of 24-and 36-percent limited partnership interests, respectively, and were given corresponding percentages of the Trust's capital account balance. The limited partnership interests held by Michael and Lynn were designated as "Class B Limited Partnership Interest[s]" and were entitled to 60 percent of the income and loss of the entity, with 40 percent thereof going to Michael and 60 percent to Lynn.

The Amendment also reclassified the Trust's remaining 39- percent limited partnership interest as a "Class A Limited Partnership Interest" which was entitled to 39 percent of the entity's income and losses and to a "Guaranteed Payment" of "4.25% annually of its Capital Account balance on the Effective Date, payable quarterly no later than twenty (20) days after the close of any such calendar quarter (or sooner, if cash flow permits)." Decedent, as trustee of the Trust, Michael, and Lynn signed the document.

On July 26, 1994, decedent commenced the process of transferring the Trust's portfolio to the partnership, which process continued for approximately the next 4 months. On July 26, 1994, decedent executed as trustee an allonge endorsement assigning to HFLP the Trust's interest in the Marsh note. A collateral assignment of the Trust's interest in property securing the note was also signed on that date. Then, on August 28, 1994, a letter agreement confirming and/or finalizing the transfer was executed by or on behalf of Mr. Marsh, the Trust, and HFLP.

Next, a letter dated September 29, 1994, was sent by decedent to M. L. Stern & Co. confirming instructions for (1) the sale of all securities held in the Trust's account and (2) the use of the proceeds for the immediate repurchase of the same securities for an account established on behalf of the partnership. Michael, as managing general partner, completed the requisite form opening a new account

> with M. L. Stern & Co. for the partnership. The form designated Michael as the "individual * * * authorized to enter orders on behalf of customer". Neil Hattem served as decedent's broker and subsequently as the broker on the HFLP account.
>
> Letters dated September 30, 1994, were then sent by decedent to Putnam Investor Services and to Franklin Templeton requesting transfer of the respective Putnam and Franklin Fund accounts to HFLP. Lastly, by a letter dated November 22, 1994, decedent requested transfer of the Trust's stock in Rockefeller Center Properties to the partnership.
>
> During this period, on September 23, 1994, Michael opened a checking account at Bank of America in the name of the partnership with a $200 deposit. Thereafter, the first activity in the account, other than the debiting of a monthly service charge, was a deposit on October 13, 1994, of $3,750 representing interest paid on the Marsh note.

The Tax Court concluded that there was an implicit agreement that the decedent would retain enjoyment (economic benefit) of the assets transferred. The opinion states:

> In <u>Estate of Reichardt v. Commissioner</u>, supra at 147-148, the decedent formed a family limited partnership, the general partner of which was a revocable trust created on the same date. The decedent and his two children were named as cotrustees, but only the decedent performed any meaningful functions as trustee. Id. at 147, 152. He was the only trustee to sign the articles of limited partnership, to open brokerage accounts, or to sign partnership checks. Id. at 152. He transferred his residence and all of his other property (except for his car, personal effects, and a small amount of cash in his checking account) to the partnership and subsequently gave his two children limited partnership interests. Id. at 148-149, 152-153. The decedent deposited partnership income in his personal account, used the partnership checking account as his personal account, and lived at his residence without paying rent to the partnership. Id. at 152. Based on these facts, we concluded that nothing but legal title changed in the decedent's relationship to his assets after he transferred them to the partnership. Id. at 152-153.
>
> In <u>Estate of Schauerhamer v. Commissioner</u>, supra, the decedent formed three limited partnerships. The decedent and one of her three children were named as the general partners of each partnership, with the decedent's being designated as the managing partner. Id. The decedent transferred business assets, including real estate, partnership interests, and notes receivable, to the partnerships in undivided one-third shares. Id. Limited partnership interests in these entities were given to family members. Id. Partnership bank accounts were opened, but the decedent deposited the income earned by the partnerships into the account she used as her personal checking account, where it was commingled with funds from other sources. Id. Checks were then written from this account to pay both personal and partnership expenses. Id. The decedent's children later acknowledged at trial that formation of the partnerships was merely a way to enable the decedent to assign interests in the partnership assets to family members, with the assets to be managed by the decedent exactly as in the past. Id. We therefore found the assets includable under section 2036(a). Id.
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> *   *   *

As regards commingling of funds, we note that this fact was one of the most heavily relied upon in both Estate of Reichardt v. Commissioner, supra at 152, and Estate of Schauerhamer v. Commissioner, supra. We find the disregard here for partnership form to be equally egregious. The Agreement specified: "All funds of the Partnership shall be deposited in a separate bank account or accounts". Yet no such account was even opened for HFLP until September 23, 1994, more than 3 months after the entity began its legal existence. Prior to that time, partnership income was deposited in the Trust's account, resulting in an unavoidable commingling of funds.

Michael testified concerning this delay as follows:

> Inadvertently, either my account or I failed to apply timely for any — an employee [sic] identification number. That is required before a checking account is open. So I just made the determination that without a checking account and I wanted the flow of cash, what we would do is use the Morton B. Harper Trust account as a holding account, and then I instructed the accountant to properly credit and account for those funds. * * *

This explanation, however, seems to beg the question. Had Michael sought promptly upon HFLP's creation to establish a bank account, he would have been immediately alerted to the need for an EIN. Hence, he either neglected to attempt opening and/or using an account or allowed the lack of an EIN to continue for several months after having been reminded of its necessity. Both reflect at best a less than orderly approach to the formal partnership structure so pressed by the estate.

Moreover, we find Michael's reliance on post mortem accounting manipulations to be especially unavailing. Michael and Mr. Blankstein, HFLP's accountant, each testified that no moneys actually changed hands in connection with the adjustments.

* * *

Closely related to the delay in opening the partnership bank account and consequent commingling of income is the delay in formally transferring the underlying portfolio assets to HFLP. No attempt was made to begin the process of title transfer until July 26, 1994, when decedent executed an allonge endorsement assigning the Marsh note to HFLP. No action was taken with respect to any of the other securities until September 29 and 30, 1994, when letters addressing transfer of the M. L. Stern & Co., Putnam, and Franklin accounts were drafted and an account with M. L. Stern & Co. was opened on behalf of HFLP. A letter requesting transfer of the Rockefeller Center Properties stock was not prepared until November 22, 1994.

When Michael was asked on cross-examination to explain this delay between the effective date of the partnership and the formal transfer of assets into the entity, he replied: "Probably for different reasons, some mechanical delays and who we're dealing with, but generally, there was no rush to do it. We were just doing it in an orderly fashion." Next, in response to a further question asking why there was no rush, he continued: "There was no rush. I mean, we were just handling the business in an orderly fashion. There wasn't any deadline or urgency to do it and get it done."

The estate also argued that the partnership units were consideration sufficient to move the transaction out of section 2036. The court rejected the contention:

> Having decided that decedent retained enjoyment of the transferred assets for purposes of section 2036(a), we turn to the question whether the statute's application may nonetheless be avoided on the basis of the parenthetical exception for "a bona fide sale for an adequate and full consideration in money or money's worth". The estate contends:
>
>> The primary reason why I.R.C. 2036 does not apply to Petitioner is that the Trust's transfer of the Portfolio to the Partnership in exchange for a credit to its capital account for 99% of the fair market value of the Portfolio assets and a 99% interest in profits and losses is a "bona fide sale for an adequate and full consideration in money or money's worth." * * *
>
> We, however, disagree on the ground that the estate's position fails to take into account significant aspects of the jurisprudence addressing this exclusionary language. The phrase, as used in a predecessor statute, was explained in early caselaw of this Court, as follows:
>
>> Accordingly, the exemption from tax is limited to those transfers of property where the transferor or donor has received benefit in full consideration in a genuine arm's length transaction; and the exemption is not to be allowed in a case where there is only contractual consideration but not "adequate and full consideration in money or money's worth." * * * [Estate of Goetchius v. Commissioner, 17 T.C. 495, 503 (1951).]
>
> * * *
>
> On the facts before us, HFLP's formation at a minimum falls short of meeting the bona fide sale requirement. Decedent, independently of any other anticipated interest-holder, determined how HFLP was to be structured and operated, decided what property would be contributed to capitalize the entity, and declared what interest the Trust would receive therein. He essentially stood on both sides of the transaction and conducted the partnership's formation in absence of any bargaining or negotiating whatsoever. It would be an oxymoron to say that one can engage in an arm's-length transaction with oneself, and we simply are unable to find any other independent party involved in the creation of HFLP.
>
> Furthermore, lack of a bona fide sale aside, we believe that to call what occurred here a transfer for consideration within the meaning of section 2036(a), much less a transfer for an adequate and full consideration, would stretch the exception far beyond its intended scope. In actuality, all decedent did was to change the form in which he held his beneficial interest in the contributed property. We see little practical difference in whether the Trust held the property directly or as a 99-percent partner (and entitled to a commensurate 99-percent share of profits) in a partnership holding the property. Essentially, the value of the partnership interest the Trust received derived solely from the assets the Trust had just contributed. Without any change whatsoever in the underlying pool of assets or prospect for profit, as, for example, where others make contributions of property or services in the interest of true joint ownership or enterprise, there exists

> nothing but a circuitous "recycling" of value. We are satisfied that such instances of pure recycling do not rise to the level of a payment of consideration. To hold otherwise would open section 2036 to a myriad of abuses engendered by unilateral paper transformations.
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> * * *
>
> We therefore hold that where a transaction involves only the genre of value "recycling" described above and does not appear to be motivated primarily by legitimate business concerns, no transfer for consideration within the meaning of section 2036(a) has taken place. Hence, the exception provided in that statute is inapplicable. Furthermore, although section 2043 can entitle taxpayers to an offset for partial consideration in cases where a transfer is otherwise subject to section 2036, this section, too, is inapplicable where, as here, there has been only a recycling of value and not a transfer for consideration.

On June 17, 2002 the Fifth Circuit remanded Estate of Strangi, now called Rosalie Gulig v. Commissioner, No. 01-60538, so that the Tax Court could consider section 2036. In Strangi the decedent's attorney-in-fact formed the partnership two month's before the decedent's death. The decedent retained a 99% limited interest and a 47% interest in the 1% corporate general partner. The decedent's children paid for the other shares in the general partner. Over 75% of the partnerships' assets were marketable securities. The point here is not only section 2036(a)(1) but also 2036(a)(2), namely that by having an interest in the general partner the decedent had the right to designate those who would enjoy property.

In its initial Strangi opinion, which did not consider section 2036, the Tax Court first determined that the "business purposes" for the partnership were bogus but that the partnership would be respected anyway because the partnership was validly formed under state law. The Tax Court then rejected the applicability of section 2703 and went on to consider whether there was a gift on formation:

> In this case, the estate claims that the assets were transferred to SFLP for the business purposes discussed above. Following the formation of SFLP, decedent owned a 99-percent limited partnership interest in SFLP and 47 percent of the corporate general partner, Stranco. Even assuming arguendo that decedent's asserted business purposes were real, we do not believe that decedent would give up over $3 million in value to achieve those business purposes.
>
> Nonetheless, in this case, because we do not believe that decedent gave up control over the assets, his beneficial interest in them exceeded 99 percent, and his contribution was allocated to his own capital account, the instinctive reaction that there was a gift at the inception of the partnership does not lead to a determination of gift tax liability. In a situation such as that in Kincaid, where other shareholders or partners have a significant interest in an entity that is enhanced as a result of a transfer to the entity, or in a situation such as Shepherd v. Commissioner, 115 T.C. __, __ (2000) (slip. op. at 21), where contributions of a taxpayer are allocated to the capital accounts of other partners, there is a gift. However, in view of decedent's continuing interest in SFLP and the reflection of the contributions in his own capital account, he did not transfer more than a minuscule proportion of the value that would be "lost" on the conveyance of his assets to the partnership in exchange for a partnership interest. See Kincaid v.

> United States, supra at 1224. Realistically, in this case, the disparity between the value of the assets in the hands of decedent and the alleged value of his partnership interest reflects on the credibility of the claimed discount applicable to the partnership interest. It does not reflect a taxable gift.

Clearly the court thought another theory should be asserted, but was not — section 2036:

> The actual control exercised by Mr. Gulig, combined with the 99-percent limited partnership interest in SFLP and the 47- percent interest in Stranco, suggest the possibility of including the property transferred to the partnership in decedent's estate under section 2036. See, e.g., Estate of Reichardt v. Commissioner, 114 T.C. 144 (2000). Section 2036 is not an issue in this case, however, because respondent asserted it only in a proposed amendment to answer tendered shortly before trial. Respondent's motion to amend the answer was denied because it was untimely. Applying the economic substance doctrine in this case on the basis of decedent's continuing control would be equivalent to applying section 2036(a) and including the transferred assets in decedent's estate. As discussed below, absent application of section 2036, Congress has adopted an alternative approach to perceived valuation abuses.

The IRS expert allowed a 31% discount which the court, reluctantly, accepted.

The Fifth Circuit stated on remand:

> Fifty-two days before trial, the Commissioner filed a motion to amend to add a claim that under §§ 2036 the estate should include the value of SFLP's assets transferred from the decedent. The tax court denied the motion to amend, apparently because it considered the motion untimely. We review the tax court's decision to deny leave to amend for abuse of discretion. Halbert v. City of Sherman, Tex., 33 F.3d 526, 529 (5th Cir. 1994). "A decision to grant leave is within the discretion of the court, although if the court lacks a substantial reason to deny leave, its discretion is not broad enough to permit denial." State of Louisiana v. Litton Mortgage Co., 50 F.3d 1298, 1302-03 (5th Cir. 1995) (internal citations and quotes omitted). "In the absence of any apparent or declared reason — such as undue delay, bad faith or dilatory motive on the part of the movant, repeated failure to cure deficiencies by amendments previously allowed, undue prejudice to the opposing party by virtue of allowance of the amendment, futility of amendment, etc. — the leave sought should, as the rules require, be 'freely give.'" Foman v. Davis, 371 U.S. 178, 182 (1962).
>
> The only insight we have into the tax court's reasoning for the denial is its statement that, even though §§ 2036 might apply on the facts, it was "not an issue in this case, however, because respondent asserted it only in a proposed amendment to answer tendered shortly before trial. Respondent's motion to amend the answer was denied because it was untimely." However, the motion was made nearly two months, not "shortly," before trial and was unlikely to cause delay or prejudice. If the tax court's true reasoning was that the Commissioner could have sought to assert the applicability of §§ 2036 earlier in the proceedings, it did not assert such and did not discuss any evidence of bad faith or dilatory motive. We cannot assume bad faith on the record here. The record does not present an obvious reason for denial of leave to amend. See Ashe v. Corley, 992 F.2d 540, 542-43 (5th Cir. 1993) ("Where reasons for denying leave to amend are 'ample and obvious,' the district court's failure to

> articulate specific reasons does not indicate an abuse of discretion."). We find that the denial was an abuse of discretion.

Judge Cohen issued the second Tax Court opinion in Strangi on May 20, 2003. T. C. Memo 2003 - 145. The opinion is not a reviewed decision. The opinion deals with both section 2036(a)(1) and 2036(a)(2). The latter analysis will cause more concern. The opinion summarizes the relevant facts as follows:

> The SFLP agreement provides that distributions of proceeds and assets from the entity shall be made in the sole discretion of the managing general partner. The SFLP agreement also designates Stranco as the managing general partner. Stranco, in turn, executed the management agreement employing Mr. Gulig to manage the day-to-day business of SFLP, as well as of Stranco itself. Yet Mr. Gulig was already decedent's attorney in fact pursuant to the 1988 general power of attorney. Under this instrument, Mr. Gulig was granted full and durable authority to act for decedent in his "name, place and stead". Mr. Gulig set up the SFLP/Stranco arrangement to facilitate decedent's estate planning goals and capitalized the partnership primarily with decedent's property.
>
> When distilled to their most essential terms, the governing documents gave Mr. Gulig authority to specify distributions from SFLP, which is entirely consistent with his authority under the 1988 power of attorney. Although the estate protests that Mr. Gulig's authority under the management agreement was limited to managing "the day-to-day business" of the partnership and did not extend to making distributions or loans, the pertinent instruments provide no basis for concluding that making distributions would be outside the day-to-day business of a partnership capitalized nearly exclusively with investment assets. As a practical matter, actual disbursement of funds occurred when checks were issued by Mr. and Mrs. Gulig in their various related capacities, pursuant to rights granted to them by decedent, acting through Mr. Gulig.
>
> Hence, to summarize, the SFLP agreement named Stranco managing general partner with the sole discretion to determine distributions. The Stranco shareholders, including decedent (through Mr. Gulig), then acted together to delegate such authority to Mr. Gulig under the management agreement. Decedent's attorney in fact thereby stood in a position to make distribution decisions. Mrs. Gulig effectuated these decisions by signing checks to the recipients so designated.

The first issue for the court was the application of section 2036(a)(1). The taxpayer attempted to distinguish this case from the Schauerhamer to Reichardt and Harper line of cases. The court acknowledged that the taxpayer here dotted more "i's" and crossed more "t's" than in the aforementioned cases but ultimately reached the same result. Judge Cohen writes:

> At the outset, we acknowledge that, in contrast to certain of the prior cases, the participants involved in the SFLP/Stranco arrangement generally proceeded such that "the proverbial 'i's were dotted' and 't's were crossed'." Strangi I at 486. Steps were taken to abide by the formal terms of the structure created. Such measures may give SFLP and Stranco sufficient substance to be recognized as legal entities in the context of valuation, which requires assumption of a hypothetical buyer and seller. They do not preclude implicit retention by

decedent of economic benefit from the transferred property for purposes of section 2036(a)(1).

First, we cannot lose sight of the fact that decedent contributed approximately 98 percent of his wealth, including his residence, to the SFLP/Stranco arrangement. Respondent alleges that the transfer left decedent with inadequate assets and cash flow to meet his living expenses, to which the estate takes objection. The estate goes to great lengths to counter respondent's assertion, claiming that decedent at his death possessed liquefiable assets of at least $172,000 and received on a monthly basis a pension of $1,438.18 and Social Security of $1,559. The estate also stresses that respondent has not established the amount of decedent's living expenses and maintains that, even if the $33,323.22 in checks paid from decedent's account in August and September were used as an estimate, the purported liquefiable assets would have covered decedent's needs for his concededly short life expectancy of 12 to 24 months. However, the relative dearth of liquefied (decedent's Form 706 showed two bank accounts with funds totaling $762), as opposed to "liquefiable", assets persuades us that decedent and his children and Mr. Gulig all expected that SFLP and Stranco would be a primary source of decedent's liquidity. It is unreasonable to expect that decedent would be forced to rely on sale of assets to meet his basic costs of living.

A second feature highly probative under section 2036(a)(1) is decedent's continued physical possession of his residence after its transfer to SFLP. The estate maintains that any otherwise negative implications of this circumstance are neutralized by the fact that SFLP "charged Mr. Strangi rent" on occupancy of the home and reported rental income on its 1994 tax return. Decedent likewise reported a rent obligation on his estate tax return. For accounting purposes, the accrued rent was recorded by SFLP on its books. Yet the accrued amount was not paid until January 1997. A residential lessor dealing at arm's length would hardly be content merely to accrue a rental obligation for eventual payment more than 2 years later. As we have remarked, accounting entries alone are of small moment in belying the existence of an agreement for retained possession and enjoyment. Estate of Reichardt v. Commissioner, 114 T.C. at 154-155; Estate of Harper v. Commissioner, T.C. Memo. 2002-121.

Concerning factors that relate to use of entity funds, the estate emphasizes that each disbursement for decedent or his estate was accompanied by a pro rata allotment to Stranco. Where, as here, the only interest in the partnership other than that held by the decedent is de minimis, a pro rata payment is hardly more than a token in nature. In these circumstances, pro rata disbursements are insufficient to negate the probability that the decedent retained economic enjoyment of his or her assets. After all, distributing 1 percent to Stranco would not in any substantial way operate to curb decedent's ability to benefit from SFLP property. Accordingly, we direct our attention to the purpose, as opposed to the mechanics, of partnership distributions and expenditures.

The record reveals several instances where SFLP expended funds in response to a need of decedent or his estate. SFLP paid for Ms. Stone's back surgery to alleviate an injury she sustained in caring for decedent prior to the formation of SFLP. In 1994, SFLP expended nearly $40,000 for funeral expenses, estate administration, and related debts, including a $19,810.28 check to Olsten to pay for nursing services rendered to decedent before his death. These sums were followed in 1995 and 1996 by further payment of over $65,000 for estate expenses and a specific bequest. SFLP also disbursed approximately $3 million directed toward decedent's estate and inheritance taxes.

The estate seeks to justify these payments primarily by emphasizing that they were accounted for on SFLP's books as advances to partners and later closed as distributions, with pro rata amounts either advanced or distributed to Stranco. The evidence also indicates that the $65,000-plus amount was repaid in January 1997. The estate further explains that certain of these payments from SFLP were necessitated by the delay in probate of decedent's estate engendered by the process of getting TCB to decline executorship.

To the extent that the estate's arguments focus on accounting manipulations, they are unavailing. As demonstrated in Estate of Reichardt v. Commissioner, supra at 154-155, and Estate of Harper v. Commissioner, supra, accounting adjustments do not preclude a conclusion that those involved understood that the decedent's assets would be made available as needs materialized. Belated repayment of certain amounts likewise does not refute the inference of an implicit agreement for retained enjoyment that arises from the demonstrated and contemporaneous availability of large sums. Furthermore, to the extent that the estate's explanations focus on a delay in probate, they lack specificity. The more salient feature would appear to be the insufficiency of the assets not contributed to SFLP and Stranco to cover the significant expenses reasonably to be expected to ensue in connection with decedent's poor health and death. That, in turn, speaks to retained enjoyment.

Regarding testamentary characteristics, the SFLP/Stranco arrangement also bears greater resemblance to one man's estate plan than to any sort of arm's-length, joint enterprise. As in Estate of Harper v. Commissioner, supra, "the largely unilateral nature of the formation, the extent and type of the assets contributed thereto, and decedent's personal situation are indicative." Mr. Gulig established the entities using Fortress documents with little, if any, input from other family members. The contributed property included the majority of decedent's assets in general and his investments, a prime concern of estate planning, in particular. Decedent was advanced in age and suffering from serious health conditions. Furthermore, as discussed in Strangi I at 485-486, the purpose of the partnership arrangement was not to provide a joint investment vehicle for the management of decedent's assets, but was consistent with testamentary intent.

Moreover, the crucial characteristic is that virtually nothing beyond formal title changed in decedent's relationship to his assets. Mr. Gulig managed decedent's affairs both before and after the transfer. Decedent's children did not obtain a meaningful economic stake in the property during decedent's life. They raised no objections or concerns when large sums were advanced for expenditures of decedent or his estate, thus implying an understanding that decedent's access thereto would not be restricted.

In face of the foregoing realities, the estate argues that whatever possession or enjoyment of the contributed property decedent may have experienced was neither "retained" by means of a contemporaneous agreement nor "with respect to the transferred property". As regards the first point, the estate contends that respondent has offered no evidence to prove a contemporaneous agreement requiring the distributions made, as opposed to an independent subsequent decision by Stranco to make the same outlay. According to the estate:

> Even if decisions to make distributions were made based on "sympathy for poor old dad," i. e., "Oops, Mr. Strangi imprudently put too much money into SFLP and we need to give some back" that would not meet the criteria set by judicial precedent for determining the existence of a retained expectation of possession of [sic] enjoyment: which is that there must have been an implied agreement that was contemporaneous with the transfer of the property at issue, not a subsequent agreement or act. * * * [Fn. ref. omitted.]

We are persuaded that the evidence and circumstances detailed above render such a contemporaneous agreement more likely than not.

The second point mentioned stems from the estate's view that pro rata distributions were made not with respect to the transferred property, in which decedent possessed no legal interest under the Texas Revised Limited Partnership Act (TRLPA), Tex. Rev. Civ. Stat. Ann. art. 6132a-1, sec. 7.01 (Vernon Supp. 2003), but with respect to his partnership interest. Yet this argument relies on paper title to the exclusion of the practicalities that are the focus of section 2036(a)(1). The property contributed by decedent was the source of the payments made. Furthermore, the record suggests that the impetus underlying a number of significant SFLP disbursements was needs of decedent or his estate, rather than exigencies pertaining to Stranco or the partnership itself.

To this point, the opinion has been a bit more aggressively anti-taxpayer than the previous 2036(a)(1) cases have been, but nonetheless the issues raised were essentially the same. However, the court did not stop there. Noting that the taxpayer and the government argued extensively about the application of section 2036(a)(2) the court decided to weigh in. (So, before going further, remember this is arguably dicta in an unreviewed Tax Court opinion.)

Judge Cohen describes the application of section 2036(a)(2) and the meaning of Byrum as follows:

As stated above, section 2036(a)(2) mandates inclusion in the gross estate of transferred property with respect to which the decedent retained the right to designate the persons who shall possess or enjoy the property or its income. This provision was interpreted by the Supreme Court in United States v. Byrum, 408 U.S. 125 (1972), and both parties devote a significant portion of their respective arguments to the implications of that decision. We address these arguments as an alternative to our conclusions concerning section 2036(a)(1) and with particular consideration of the facts of this case.

In United States v. Byrum, supra at 126, the decedent, Mr. Byrum, created an irrevocable trust for the benefit of his children. He funded the trust with shares of three closely held corporations but retained the right to vote the shares and to veto any sale or transfer of the stock. Id. at 126-127. As a result, Mr. Byrum at his death continued to have the right to vote not less than 71 percent of the common stock in each of the three corporations. Id. at 128-129. The three corporations were involved in lithography-related businesses and had a substantial number of minority shareholders unrelated to Mr. Byrum. Id. at 130 & n. 2, 142 & n.20. (The Supreme Court noted that 11 of 12, 5 of 8, and 11 of 14 stockholders, respectively, in the three corporations appeared to be unrelated to Mr. Byrum. Id. at 142 n.20.) The trust instrument specified that there be, and

Mr. Byrum named, an independent corporate trustee. Id. at 126. The trustee was authorized in its "absolute and sole discretion" to pay income and principal to or for the benefit of the beneficiaries. Id. at 127.

The Commissioner argued that, by retaining voting control over the corporations, Mr. Byrum was in a position to select the corporate directors and thereby to control corporate dividend policy. Id. at 131-132. According to the Commissioner, the scenario in dispute gave Mr. Byrum the ability to regulate the flow of income to the trust, which ability was characterized as tantamount to a grantor-trustee's power to accumulate trust income for remaindermen or to distribute to present beneficiaries. Id. at 132. The Court had previously ruled that the latter power to accumulate rather than disburse constituted a right to designate under section 2036(a)(2). Id. at 135-136; United States v. O'Malley, 383 U.S. 627, 631 (1966).

Given the above facts, the Supreme Court held "that Byrum did not have an unconstrained de facto power to regulate the flow of dividends to the trust, much less the 'right' to designate who was to enjoy the income from trust property." United States v. Byrum, 408 U.S. at 143. The Court rejected the Commissioner's "control rationale" as it "would create a standard — not specified in the statute — so vague and amorphous as to be impossible of ascertainment in many instances." Id. at 137 n. 10. In reaching its conclusion, the Court relied on a series of "economic and legal constraints" to which any power that Mr. Byrum might have had was subject and which prevented such power from being equivalent to a right to designate persons to enjoy trust income. Id. at 144.

The Court emphasized that the independent corporate trustee alone had the right under the trust instrument to pay out or withhold income. Id. at 137. Even if Mr. Byrum had managed to flood the trust with dividends, he had no way of compelling the trustee to pay out or accumulate that income. Id. at 143. The Court also noted that the power to elect directors conferred no legal right to command them to pay or not pay dividends. Id. at 137. Moreover, the flow of dividends from the corporations would be subject to economic vicissitudes, retained earnings policies, and business needs. Id. at 139-140. In this regard, the Court explained:

> There is no reason to suppose that the three corporations controlled by Byrum were other than typical small businesses. The customary vicissitudes of such enterprises — bad years; product obsolescence; new competition; disastrous litigation; new, inhibiting Government regulations; even bankruptcy — prevent any certainty or predictability as to earnings or dividends. There is no assurance that a small corporation will have a flow of net earnings or that income earned will in fact be available for dividends. Thus, Byrum's alleged de facto "power to control the flow of dividends" to the trust was subject to business and economic variables over which he had little or no control. [Id. at 249.]

Furthermore, the Supreme Court stressed that "A majority shareholder has a fiduciary duty not to misuse his power by promoting his personal interests at the expense of corporate interests" and the directors of a corporation "have a fiduciary duty to promote the interests of the corporation." Id. at 137-138. Such duties were legally enforceable by means of, for example, a derivative suit. Id. at 141-142.

The court then noted that in fact Mr. Strangi had the ability to designate who would receive the benefits of the partnership acting in conjunction with others, namely the general partner. The simplest illustration of the principle is that Mr. Strangi, as limited partner, could act with the general partner to liquidate the partnership, and thus receive the vast majority of the partnership assets. The opinion states:

> With respect to SFLP income and as previously recounted in greater detail, the SFLP agreement named Stranco managing general partner and conferred on the managing general partner sole discretion to determine distributions. The Stranco shareholders, including decedent (through Mr. Gulig), then acted together to delegate this authority to Mr. Gulig through the management agreement. The effect of these actions placed decedent's attorney in fact in a position to make distribution decisions. Mrs. Gulig effectuated such decisions by executing checks to the recipients so designated.
>
> In addition to the rights described above related to income, decedent also retained the right, acting in conjunction with other Stranco shareholders, to designate who shall enjoy the transferred SFLP property itself. The Supreme Court indicated in United States v. Byrum, 408 U.S. at 143 n.23 (citing Commissioner v. Estate of Holmes, 326 U.S. 480 (1946)), that a "power to terminate the trust and thereby designate the beneficiaries at a time selected by the settlor" would implicate section 2036(a)(2). Pursuant to the SFLP agreement, the partnership would be dissolved and terminated upon a unanimous vote of the limited partners and the unanimous consent of the general partner. The shareholders agreement likewise specifies that dissolution of SFLP requires the affirmative vote of all Stranco shareholders. Once dissolution and termination occur, liquidation is accomplished as set forth in the SFLP agreement. The managing general partner is named as the liquidator, which in turn disburses partnership assets first in payment of debts and then in repayment of partners' capital account balances. Authority is expressly granted for distributions in kind. Accordingly, decedent can act together with other Stranco shareholders essentially to revoke the SFLP arrangement and thereby to bring about or accelerate present enjoyment of partnership assets. Furthermore, it is noteworthy that such action would likely revest in decedent himself, as the 99-percent limited partner, the majority of the contributed property.
>
> As regards property transferred to Stranco and income therefrom, decedent held the right, in conjunction with one or more other Stranco directors, to declare dividends. The corporation's bylaws authorize the board of directors to declare dividends from the entity. For the board to take such action, a majority vote of the directors at a meeting with a quorum present is sufficient. Under the bylaws, a majority of the directors then serving constitutes a quorum. Because Stranco had five directors, a quorum would consist of three, so two directors (e. g., decedent through Mr. Gulig and one other) could potentially act together to declare a dividend. The Stranco shareholders agreement further provided that each of the initial five directors would be reelected annually, thus effectively ensuring decedent's position on the board.
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> In response to various of the above concepts pertaining to joint action, particularly by stockowners, the estate suggests: "If the mere fact that a shareholder could band together with all of the other shareholders of a corporation and such banding together would be sufficient to cause inclusion under Section 2036, then it would have been impossible for the United States Supreme Court to reach the decision that it did in Byrum." The estate's

> observation ignores the existence in United States v. Byrum, supra, of the independent trustee who alone had the ability to determine distributions from the disputed trust, notwithstanding any prior action by corporate owners or directors. It also ignores the identity of the shareholders in this case and the dual roles played by Mr. Gulig.
>
> To summarize, review of the documentary evidence discussed above reveals that decedent here retained rights of a far different genre from those at issue in United States v. Byrum, supra. Rather than mere "control", management, or influence, there are traceable to decedent through the explicit provisions of the governing instruments ascertainable and legally enforceable rights to designate persons who shall enjoy the transferred property and its income. The estate's reliance on a limited partner's lack under the TRLPA of participation in control and under the SFLP agreement of management authority is thus misplaced. The alleged absence of such powers cannot negate the dispositive rights granted in the instant case. The SFLP/Stranco arrangement placed decedent in a position to act, alone or in conjunction with others, through his attorney in fact, to cause distributions of property previously transferred to the entities or of income therefrom. Decedent's powers, absent sufficient limitation as discussed infra, therefore fall within the purview of section 2036(a)(2).

What about the fiduciary duty argument that saved the taxpayer in Byrum? The court gave the argument short-shrift finding that the fiduciary duties which existed mostly ran to Mr. Strangi himself:

> The fiduciary duties present in United States v. Byrum, 408 U.S. 125 (1972), ran to a significant number of unrelated parties and had their genesis in operating businesses that would lend meaning to the standard of acting in the best interests of the entity. As a result, there existed both a realistic possibility for enforcement and an objective business environment against which to judge potential dereliction. Given the emphasis that the Supreme Court laid on these factual realities, Byrum simply does not require blind application of its holding to scenarios where the purported fiduciary duties have no comparable substance. We therefore analyze the situation before us to determine whether the fiduciary duties relied upon by the estate would genuinely circumscribe use of powers to designate.
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> The estate summarizes its contentions regarding fiduciary duties as follows:
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>> Just like Mr. Byrum, Mr. Strangi's "rights" (whatever those rights appear to be) were severely limited by the fiduciary duties of other people who (according to Byrum) presumably could be counted on the [sic] observe those restraints against whatever desires they might otherwise have had to run pell-mell to do the bidding of the Decedent: (1) Mr. Gulig, who (separate and apart from his role as attorney-in-fact for Mr. Strangi) had fiduciary duties to Stranco, whom he served as manager; (2) the directors of Stranco, who had fiduciary duties to both Stranco and to SFLP as a whole; and (3) McLennan County Community College ("MCCC"), which had rights as a minority shareholder of Stranco and a fiduciary obligation to enforce such rights for the benefit of its own beneficiaries as well as the people of the State of Texas (with the Attorney General of Texas having the ability to step in to enforce such rights if MCCC failed in its duties). * * *

> None of the foregoing obligations cited by the estate is sufficiently on par with those detailed in United States v. Byrum, supra, to bring the present case within the Supreme Court's rationale.
>
> Concerning Mr. Gulig, any fiduciary duties that Mr. Gulig might have had in his role as manager of Stranco (and thereby of SFLP) are entitled to comparatively little weight on these facts. Prior to his instigation of the SFLP/Stranco arrangement, Mr. Gulig stood in a confidential relationship, and owed fiduciary duties, to decedent personally as his attorney in fact. Thus, to the extent that Stranco or SFLP's interests might diverge from those of decedent, we do not believe that Mr. Gulig would disregard his preexisting obligation to decedent.
>
> As regards fiduciary obligations of Stranco and its directors, these duties, too, have little significance in the present context. Although Stranco would owe a fiduciary duty to SFLP and to the limited partners, decedent owned the sole, 99-percent limited partnership interest. The rights to designate traceable to decedent through Stranco cannot be characterized as limited in any meaningful way by duties owed essentially to himself. Nor do the obligations of Stranco directors to the corporation itself warrant any different conclusion. Decedent held 47 percent of Stranco, and his own children held 52 of the remaining 53 percent. Intrafamily fiduciary duties within an investment vehicle simply are not equivalent in nature to the obligations created by the United States v. Byrum, supra, scenario.
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> With respect to the role of MCC Foundation, United States v. Byrum, supra, affords no basis for permitting outcomes under section 2036(a)(2) to turn on factors amounting to no more than window dressing. A charity given a gratuitous 1-percent interest would not realistically exercise any meaningful oversight.

Finally, and not unsurprisingly, Judge Cohen concluded that the arrangement had not been entered into for full and adequate consideration. She writes:

> We see no distinction of consequence between the scenario analyzed in Estate of Harper v. Commissioner, supra, and that of the present case. Decedent contributed more than 99 percent of the total property placed in the SFLP/Stranco arrangement and received back an interest the value of which derived almost exclusively from the assets he had just assigned. Furthermore, the SFLP/Stranco arrangement patently fails to qualify as the sort of functioning business enterprise that could potentially inject intangibles that would lift the situation beyond mere recycling. Cf. Estate of Harrison v. Commissioner, T.C. Memo. 1987-8; Church v. United States, 85 AFTR 2d 2000-804, 2000-1 USTC par. 60,369 (W.D. Tex. 2000), affd. without published opinion 268 F.3d 1063 (5th Cir. 2001) (both involving contributions by other participants not de minimis in nature, for a genuine pooling of interests). We therefore hold that decedent did not engage in any transfer for consideration upon the creation and funding of SFLP and Stranco. Accordingly, the estate is entitled to no exception to the treatment mandated by section 2036(a).

If the limited interests had been held in a marital trust included in Mr. Strangi's estate would the result have been different? What if Mr. Strangi had transferred the limited interests to a trust over which he retained a special power of appointment but no other rights? That is, if the limited partnership interests had been included in his estate but in fact he had not had the right to assist in the liquidation of the partnership would Judge Cohen have held differently? Supposing such were the case, presumable section 2035 would impose the three-year rule. Is the effect any different were the limited interests given away prior to death?

The practical effect of Strangi will be to embolden the IRS to argue against significant discounts when valuing limited partnership interests in estates. The theoretical underpinnings of Strangi are more suspect. The opinion pushes taxpayers to create partnership arrangements and avoid ever having control over the partnership. In turn, that raises the possibility that the "gift on formation" issue reappears. Arguably, the Tax Court analysis dealing with the gift on formation has not directly confronted a situation in which the Tax Court believes the creator did not retain de facto control over the partnership.

The taxpayers defeated a section 2036(a)(1) argument in Estate of Eugene E. Stone, III v. Commissioner, T.C. Memo 2003-309, because the Court found full and adequate consideration rather than a "mere recycling" of value. The Court held as follows:

> On the record before us, we agree with the estates' position and reject respondent's position. The instant cases are distinguishable from *Estate of Harper v. Commissioner, supra*, and other cases factually similar to *Estate of Harper* on which respondent relies, and respondent's reliance on such cases is misplaced. Unlike the transfers involved in *Estate of Harper* and those other cases, we have found on the record in the instant cases that the respective transfers of assets by Mr. Stone and Ms. Stone to each of the Five Partnerships, as well as the respective transfers of assets by the other partners to each such partnership, were bona fide, arm's-length transfers.
>
> On the record before us, we reject respondent's contention that, because Mr. Stone and Ms. Stone did not actively participate in the negotiations by the children, the respective transfers of assets by Mr. Stone and Ms. Stone to each of the Five Partnerships were not bona fide, arm's-length transfers. Each member of the Stone family was represented by his or her own independent counsel and had input into the decision-making as to how each of the Five Partnerships was to be structured and operated and what property was to be transferred to each such partnership. The Stone family understood that Mr. Stone and Ms. Stone would not be bound by any agreements that the children were able to reach as a result of the children's negotiations and that Mr. Stone and Ms. Stone would make the ultimate decision as to which, if any, of their respective assets to transfer to each of the Five Partnerships. In this connection, although Mr. Stone and Ms. Stone agreed to form the Five Partnerships, they did not intend to, and did not, transfer all their respective assets to such partnerships. Instead, they retained sufficient assets to enable them to maintain their respective accustomed standards of living. Mr. Stone and Ms. Stone did not accept the children's recommendations resulting from the children's negotiations regarding the structure, funding, and operation of the Five Partnerships without thought, comment, or question. For example, it was Mr. Merline, Mr. Stone's attorney, who drafted proposed partnership agreements for the Five Partnerships. Mr. Merline discussed with Mr. Stone the children's and their respective attorneys' suggested changes to those proposed agreements. Only after Mr. Stone agreed to certain of those suggested changes did Mr. Merline revise the proposed partnerships agreements to reflect the changes to which Mr. Stone agreed.

The record also establishes that the respective transfers at issue did not constitute gifts by Mr. Stone and Ms. Stone, respectively, to the other partners of each of the Five Partnerships. In addition, the record shows that those transfers were motivated primarily by investment and business concerns relating to the management of certain of the respective assets of Mr. Stone and Ms. Stone during their lives [and thereafter and the resolution of the litigation among the children.

Unlike the decedent in Estate of Harper and other cases factually similar to that case, the record in the instant cases establishes that Mr. Stone and Ms. Stone did substantially more than "change the form in which he [and she] held his [and her] beneficial interest in the contributed property." Estate of Harper v. Commissioner, T.C. Memo. 2002-121. The record in the instant cases shows that the Five Partnerships had economic substance and operated as joint enterprises for profit through which the children actively participated in the management and development of the respective assets of such partnerships during their parents' lives (and thereafter). When the partners of ES3LP formed and funded that partnership, they contemplated and intended that ES3LP operate as a joint enterprise for profit for the management of its assets and that the children contribute their services in providing such management. After ES3LP was funded in April 1997, the children actively managed the assets of that partnership, as Mr. Stone and Ms. Stone intended. When the partners of ES4LP formed and funded that partnership, they contemplated and intended that ES4LP operate as a joint enterprise for profit for the management of its assets and that Eugene Earle Stone, IV, contribute his services in providing such management. After the funding of ES4LP in April 1997, Eugene Earle Stone, IV, began actively managing the assets of ES4LP, as Mr. Stone and Ms. Stone intended. When the partners of CRSLP formed and funded that partnership, they contemplated and intended that CRSLP operate as a joint enterprise for profit for the management of its assets and that C. Rivers Stone contribute his services in providing such management. After the funding of CRSLP in April 1997, C. Rivers Stone began actively managing the assets of that partnership, as Mr. Stone and Ms. Stone intended. When the partners of RSMLP formed and funded that partnership, they contemplated and intended that RSMLP operate as a joint enterprise for profit for the management of its assets and that Ms. Morris contribute her services in providing such management. After the funding of RSMLP in April 1997, Ms. Morris began actively managing the assets of that partnership, as Mr. Stone and Ms. Stone intended. When the partners of MSFLP formed and funded that partnership, they contemplated and intended that MSFLP operate as a joint enterprise for profit for the management of its assets and that Ms. Fraser contribute her services in providing such management. After the funding of MSFLP in April 1997, Ms. Fraser began actively managing the assets of that partnership, as Mr. Stone and Ms. Stone intended.

On the record in the instant cases, we find that, unlike the transfers involved in Estate of Harper and other cases factually similar to that case, the respective transfers at issue by Mr. Stone and Ms. Stone did not constitute "circuitous 'recycling' of value".

On the record before us, we further find that the respective transfers of assets by Mr. Stone and Ms. Stone to each of the Five Partnerships were for adequate and full consideration in money or money's worth. We have found that such transfers were not, and respondent does not claim that they were, gifts by Mr. Stone and Ms. Stone, respectively, to the other partners of each such partnership. We have also found, and respondent agrees and/or does not dispute, that after all the partners of each of the Five Partnerships transferred to each such partnership certain of their respective assets and after certain gifts were made by Mr. Stone in April 1997 to correct the unintended consequences of certain inadvertent valuation errors: (1) All partners of each of the Five Partnerships held respective partnership interests in each such partnership that were proportionate to the fair market value of the assets that such partners respectively transferred to each such partnership; (2) the respective assets that the partners of each such partnership transferred to each such partnership were properly credited to the respective capital accounts of such partners; and (3) upon the termination or dissolution of each of the Five Partnerships, the partners of each such partnership were entitled to distributions from each such partnership in amounts equal to their respective capital accounts. Under the circumstances presented in the instant cases, we find that Mr. Stone and Ms. Stone, as well as the other partners of each of the Five Partnerships, received in exchange for their respective transfers of assets to each such partnership respective partnership interests in each such partnership that were adequate and full equivalents reducible to a money value. See secs. 20.2036-1(a), 20.2043-1(a), Estate Tax Regs.; see also Estate of Goetchius, 17 T.C. at 503.

Respondent nonetheless argues that, because Mr. Stone and Ms. Stone received respective partnership interests in each of the Five Partnerships the value of which, taking into account appropriate discounts, was less than the value of the respective assets that they transferred to each such partnership, they did not receive adequate and full consideration for the assets transferred. Respondent's argument in effect reads out of section 2036(a) the exception for "a bona fide sale for an adequate and full consideration in money or money's worth" in any case where there is a bona fide, arm's- length transfer of property to a business entity (e.g., a partnership or a corporation) for which the transferor receives an interest in such entity (e.g., a partnership interest or stock) that is proportionate to the fair market value of the property transferred to such entity and the determination of the value of such an interest takes into account appropriate discounts. We reject such an argument by respondent that reads out of section 2036(a) the exception that Congress expressly prescribed when it enacted that statute.

Respondent's argument about the discounted values of the partnership interests at issue also ignores the fact that each of the Five Partnerships was created, funded, and operated as a joint enterprise for profit for the management of its assets in which there was a genuine pooling of property and services. We have found that, when the partners of each of the Five Partnerships formed and funded each such partnership, they contemplated and intended that each such partnership operate as a joint enterprise for profit for the management of its assets and that the children contribute services in providing such management in the case of ES3LP and that Eugene Earle Stone, IV, C. Rivers Stone, Ms. Morris, and Ms. Fraser contribute services in providing such management in the case of ES4LP, CRSLP, RSMLP, and MSFLP, respectively. As Mr. Stone and Ms. Stone intended, after the funding of ES3LP, the children actively participated in the management of the assets of that partnership, and after the funding of ES4LP, CRSLP, RSMLP, and MSFLP, Eugene Earle Stone, IV, C. Rivers Stone, Ms. Morris, and Ms. Fraser, respectively, actively participated in the management of the assets of such partnerships.

Based upon our examination of the entire record before us, we find that the respective transfers of assets by Mr. Stone and Ms. Stone to each of the Five

> Partnerships were bona fide sales for adequate and full consideration in money or money's worth under section 2036(a).

The Stone case is important for at least two reasons. One, that services were held bona fide contributions by the children to the various family partnerships. Two, that simple management of assets was deemed a joint enterprise.

Estate of Ida Abraham v. Commissioner, T.C. Memo 2004-39, involved 2036(a)(1). Mrs. Abraham was declared incompetent on March 10, 1993; on December 30, 1993 the guardians received court permission to make gifts on behalf of Mrs. Abraham; and on June 13, 1994 Mrs. Abraham's children and the guardians agreed upon a giving plan involving various partnerships, corporate general partners, and trusts.

Judge Ruwe held that Mrs. Abraham was always to receive the income from the assets transferred to the partnerships because that was the plan. The opinion states:

> It is clear from the documentary evidence and the testimony elicited at trial that, regardless of the form of decedent's transfers, she continued to enjoy the right to support and maintenance from all the income that the FLPs generated. According to the decree (the document which authorized the creation of the FLPs), decedent's needs for support were contemplated first from the income that the FLPs generated. Only after decedent's support needs, if any, were met did the children/limited partners receive their proportionate share of the partnership income. Decedent's support needs were treated as an obligation of the FLPs. For example, the decree provided that decedent's children
>
> > shall receive income from said * * * [FLPs] * * * after deducting from the gross income of the partnership all fees, taxes, partnership administration expenses, reserve for expenses and monies needed in the discretion of the limited Guardian ad litem * * * for Ida Abraham's support.
>
> In the decree, decedent's children agreed that they would
>
> > share equally any and all costs and expenses related to * * * the support of Ida Abraham insofar as the funds generated by Ida Abraham's properties maintained by her do not provide sufficient funds for her adequate health, safety, welfare and comfort as determined by the limited Guardian ad litem * * *
>
> The document further provided:
>
> > Ida Abraham's living arrangement shall remain in accordance with the present arrangement and every effort will be made to maintain her in "status quo." Her segregated assets shall be maintained at a level established by the limited Guardian ad litem in his sole discretion.

The Tax Court has been affirmed on appeal. Estate of Ida Abraham v. Commissioner, 2005 TNT 102-11 (1st Cir. 2005) (decided May 25, 2005). The court had little trouble with the case. Indeed, apparently the estate's primary argument was that the IRS' Notice of Deficiency was not detailed enough, an argument the court rejected as follows:

> The Estate's main argument is that the Notice was "latently ambiguous, overly broad and confusing" and failed to specify all the elements of the Commissioner's argument that under § 2036, the FLP interests were 100% taxable to the estate. The Estate argues that the Notice should have described "why the consideration was inadequate" and "the amount of consideration the Government would consider adequate," as well as "which of the alternative possession, enjoyment or right to income theories it is relying on alleging a taxable event has occurred pursuant to § 2036(a)." The Estate also argues that the Notice failed to explain how the Commissioner valued the FLP interests at the fair market values of the underlying real estate. Therefore, the Estate argues, the burden of proof on all of these "new matters" should have been placed on the Commissioner.[11]
>
> Acceptance of the Estate's arguments would amount to a requirement that the Notice of Deficiency be as detailed as trial briefs. There is no such requirement. The standard of specificity for notices of deficiency is much lower. "In fact, if a deficiency notice is broadly worded and the Commissioner later advances a theory not inconsistent with that language, the theory does not constitute new matter, and the burden of proof remains with the taxpayer." *Abatti v. Comm'r*, 644 F.2d 1385, 1390 (9th Cir. 1981); <u>see also</u> *Shea*, 112 T.C. at 191. The Commissioner did not seek to change the amount of the deficiency or advance a theory inconsistent with the language of the Notice.

On the merits, the court found a clear understanding among the parties:

> What the Tax Court did find was that "[t]he documentary evidence, including the stipulated decree of the probate court, and the understanding of decedent's children and legal representatives demonstrate that decedent was entitled to any and all funds generated from the partnership for her support <u>first</u>." *Estate of Abraham*, 87 T.C.M. (CCH) at 981 (emphasis in original). This finding is not clearly erroneous.
>
> Evidence adduced at trial shows that the motivation for the formation of the FLPs was to protect Mrs. Abraham's financial needs so as to maintain her in status quo and to prevent her estate from being drained by litigation. The FLPs were formed, according to Donna, so that "[t]here would always be money there" for Mrs. Abraham. The probate court decree memorializing the understanding of the parties at the time of the creation of the FLPs explicitly made "monies needed in the discretion of the limited Guardian ad litem . . . for Ida Abraham's support" into an obligation of the FLPs which must be met <u>before</u> any partnership income could be disbursed to the partners.
>
> The Estate chooses to focus on the FLP agreements, which do not include Mrs. Abraham's support as obligations of the FLPs, and argues that the discretion of Goldman, Mrs. Abraham's guardian ad litem and the person in control of the general partner management companies for

> the FLPs, is limited by his fiduciary duties to the other limited partners. But these arguments, at most, show that Mrs. Abraham's first-priority claim on all the income from the FLPs may not be legally enforceable. They do not show that there was no such understanding among the parties.
>
> In fact, the weight of the evidence was just the opposite. The evidence showed that all parties understood that Goldman, as Mrs. Abraham's guardian ad litem, had the discretion and the approval of the family to use all FLP income, if necessary, for Mrs. Abraham's support. Donna testified that if Mrs. Abraham's needs exceeded her share of the partnership income, "it had to come out of my partnership shares or my brother's, but the protection was there for her as a guarantee that she would live status quo." Goldman testified that he had exclusive control over the FLP accounts; he understood his authority and duties to come primarily from the court decree and also understood that he was appointed primarily to work on Mrs. Abraham's behalf. The evidence is that Goldman failed to segregate what was supposed to be Mrs. Abraham's personal funds from the funds in her revocable trust and commingled all monies in the bank accounts for the FLPs. Such commingling in disregard of the partnership form is indicative of Mrs. Abraham's retained interest over all the FLP income. See *Estate of Harper*, 83 T.C.M. (CCH) at 1649. Goldman also testified that it was his and the family's understanding that should it be necessary, all FLP income could be used to pay Mrs. Abraham's expenses, to the exclusion of paying out the shares to any of the other limited partners because that would be "what the family would have wanted."[15]
>
> Neither is it dispositive that, according to the Estate, the FLPs' payments for Mrs. Abraham's maintenance never exceeded what Mrs. Abraham was legally entitled to by virtue of her ownership of FLP percentage interests. That Mrs. Abraham's guardian ad litem did not have the occasion to, or did not choose to, exercise what was conceded to be an available option -- the diversion of all FLP income for Mrs. Abraham's maintenance -- cannot be taken to make the Tax Court's finding that this option existed clearly erroneous.

Estate of Lea K. Hillgren v. Commissioner, T.C. Memo 2004-46, also involved section 2036 (a)(1). On October 31, 1996 the decedent attempted suicide; on January 1, 1997 the decedent and her brother formed a limited partnership together; on June 5, 1997 the decedent committed suicide. The decedent and her brother had a variety of business deals together, loans between them, etc. The opinion describes the formation and operation of the partnership, known as LKHP:

> Decedent and Hillgren formed LKHP with an effective date of January 1, 1997. The term of the partnership was set for 29 years. Walsworth represented both decedent and Hillgren in the formation of the partnership. Decedent held a 99.95-percent capital interest and a 75-percent profit interest in LKHP. Decedent gave Hillgren a .05- percent capital interest and a 25-percent profit interest in the partnership. The term "profit interest" was defined in the partnership agreement as "a partnership interest other than a capital interest * * * which will give rise to a partnership capital account * * * only if and when there is

future economic income" (25-percent profit interest). The partnership agreement also provided Hillgren with 25 percent of the amount, if any, by which the partnership profits from operations in any year exceeded profits from operations realized by decedent in 1996 from the properties transferred (25-percent operational interest). The 25-percent operational interest was compensation to Hillgren for time spent in the management of LKHP. Decedent made no other gifts of partnership interests.

Decedent contributed seven properties (the LKHP properties) to LKHP, as described in exhibit B to the partnership agreement. Hillgren did not contribute any property to LKHP. The seven LKHP properties that were contributed to the partnership at its formation included the three Orange County properties and the University property that were already the subject of the BLA and that were used to fund the amended trust. In addition, the other three properties that were contributed were the Crescent Bay, Railroad, and Manzanita properties in California that also previously were used to fund the amended trust. After the initial contributions were made, no additional property was transferred to the partnership.

Decedent did not deed or transfer title to the seven LKHP properties to the partnership. The partnership agreement provided that title to any property that was contributed by a limited partner, and was deemed to be owned by the partnership, would remain in the name of the limited partner for the benefit of the partnership. The leases that encumbered the LKHP properties were not formally assigned to LKHP prior to decedent's death. The leases remained in the name of decedent, or in the name of Sea Shell [a sole proprietorship of decedent], after LKHP was formed. The title remained in the name of decedent or Sea Shell in order to hide the change of ownership from the general public and from the tenants of the properties. Under the partnership agreement, Hillgren could conduct partnership business without disclosing the existence of the partnership. The partnership was designed generally to be invisible to the public and to persons with whom decedent and Hillgren did business.

On May 27, 1997, decedent executed seven quitclaim deeds, transferring her interest in the LKHP properties to the amended trust. The deeds were unrecorded at the time of her death. Also on May 27, 1997, decedent assigned her partnership interest to the amended trust.

2. Operation of LKHP

The partnership agreement provided that the general partner need not open a bank account in the name of the partnership, but could instead maintain the existing bank account that was used by Sea Shell and the amended trust. As a result, LKHP did not have a dedicated bank account during decedent's lifetime. Decedent held a bank account at Wells Fargo Bank (Wells Fargo) that operated under the name of the amended trust, doing business as Sea Shell. The Wells Fargo account was used for operation of LKHP.

LKHP's financial statement dated June 5, 1997, and its general ledger from January 1 through June 30, 1997, included decedent's residence, the mortgage on her residence, and the mortgage and property tax payments that were made on the residence. Decedent's residence and the expenses attributed to the residence were removed from the ledger in a journal entry by an adjustment dated January 1, 1997. The adjusted journal entry was not posted until after decedent's death. It was the practice of decedent and Hillgren to post the opening entries on their accounting books anywhere from 6 to 8 months after the start of the year. As a result, the opening entries for LKHP were not made until after decedent's death. Also, the balance sheets, ledgers, and check registers that represented the financial information of LKHP were actually maintained under the name of Sea Shell.

* * *

There were no recorded minutes of any meetings of partners of LKHP. On May 13, 1999, after decedent's death, a certificate of limited partnership was filed for LKHP with the California Secretary of State.

3. LKHP Distributions

The partnership agreement provided for distributions of cash at the sole discretion of Hillgren, as the general partner. From January 1 through June 5, 1997, decedent received distributions totaling $99,363. Hillgren did not receive any distributions during this period. The distributions that were received by decedent during 1997 were made specifically to enable decedent to pay her living expenses, and she was dependent on the cashflow of the partnership to cover her personal expenses.

LKHP also paid the costs of the estate. On March 5, 1998, distributions in the amounts of $135,000 and $80,000 were made from the partnership to the amended trust. The distributions were applied to pay installments of decedent's estate taxes due to the Internal Revenue Service (IRS) and to the California State Treasurer. From 1998 until 2002, distributions were consistently made from LKHP to the amended trust to continue payment of decedent's estate taxes to the IRS and to the California Franchise Tax Board.

Judge Cohen concluded:

The estate claims that decedent was "in excellent physical health, on new antidepressant medication, and not contemplating suicide" and that, therefore, the partnership was not an alternate testamentary vehicle. The evidence contradicts this claim. Shortly before her death, decedent attempted suicide, was on various medications, was under the care of a psychiatrist, and suffered from severe pain due to degenerative disc disease. After her initial suicide attempt, LKHP was formed.

Decedent and Hillgren started many businesses over the years and disregarded entities as they saw fit, making various "situational representations", i. e., statements about their property ownership and values to support a then existing purpose, without regard to accuracy. Even the stipulated facts contain inconsistencies regarding entity names

> and dates of creation and dissolution. The stipulations of the parties were often contradicted by the documents that were provided by Hillgren. Hillgren and the estate's representatives continued to disregard the LKHP agreement both prior to and after decedent's death.

Interestingly, the taxpayer won on valuation using a different theory, namely that the decedent and her brother had previously entered into a "business loan agreement ("BLA") which was respected and had business purposes. Among other features, the decedent's brother's agreement was necessary if decedent wanted to sell any of the properties. The IRS argued the partnership superseded the BLA but Judge Cohen held the partnership had zero effect. The Form 706 had reported various discounts for different properties ranging from 35% to 50% which the court allowed.

Hillgren points out the importance of considering, and arguing for, all possible discounts, and rationales for discounts, on the Form 706 as well as in court. The Form 706 is treated a stipulation.

In Estate of Austin Korby v. Commissioner, T. C. Memo 2005-103, and Estate of Edna Korby v. Commissioner, T. C. Memo 2005-102, the Tax Court included the value of assets transferred by Mr. and Mrs. Korby into KPLP, a limited partnership, on account of section 2036. The opinions describe the circumstances leading to this holding as follows:

> We agree with respondent that an implied agreement existed between Austin, on his own behalf and on behalf of Edna, and the four Korby sons that after the assets were transferred to KPLP, income from the assets would continue to be available to Austin and Edna for as long as they needed income.[7] In 1995, when Austin and Edna transferred $1,888,704 worth of assets to KPLP, Edna was living in a nursing home and suffering from severe dementia. Edna's nursing home costs were approximately $2,500 per month. Austin had experienced a stroke and had been diagnosed with various ongoing ailments. It is reasonable to believe that Austin and Edna expected to incur significant medical expenses in the future. Austin and Edna reported medical expenses of over $37,000, approximately double their Social Security income, in each of the 4 years before they died. It was clear that the Korbys' Social Security income would not cover their basic expenses in the future. Despite their expected increased expenses, however, Austin and Edna retained in their names or the name of their living trust only their house, a vacant lot, bank accounts with a total balance of $7,428, a 1-percent interest in Crane Properties, a 2-percent interest in KPLP, and the right to receive Social Security income. KPLP paid the Korbys' home expenses after their assets were transferred to it. In order to pay the Korbys' other basic living expenses, KPLP also distributed significant percentages of its income to the living trust, ranging from 26.7 percent of its income in 1996 to 50.1 percent of its income in 1998, which paid their remaining expenses. These payments from KPLP to the living trust totaled at least 52.6 percent of the Korbys' income in each of the 4 years before they died.
>
> The estate argues that the cash payments that KPLP made to the living trust and the payments of the Korbys' home expenses were management

> fees paid for Austin's services as a money manager for the KPLP assets. The estate further claims that Austin and Edna were financially able to transfer their income-producing assets to KPLP because they expected the living trust to receive management fees that would provide enough income to them. We do not believe that the payments to the living trust were management fees. The purported fees amounted to $19,334 to $38,750 in each of the 4 years before the Korbys died. The amounts were used by the living trust to pay Edna's nursing home costs of over $30,000 per year and the Korbys' taxes, medical expenses, and other various expenses. The amounts were used entirely by Austin and Edna and not by Dennis, who was cotrustee of the general partner and was entitled to half of any management fees. While the living trust received management fees totaling over $120,000 during the years at issue, the limited partners (who owned 98 percent of KPLP) received only one distribution totaling $12,061, for taxes in 1998.
>
> Further, no management contract was executed, and the fees were paid at varying times and amounts, as Austin requested them. The purported fees were not based on any regular or prescribed method of payment or computation. Dennis testified that he caused KPLP to make payments to the living trust whenever Austin requested them because he was raised not to say no to his father. He stated that he and his father discussed the amounts of the management fees in 1995, and they wrote down the amounts on "pieces of paper" at the kitchen table. These notes regarding the purported fees were not produced by the estate at trial.

With respect to whether the transfer of assets into the partnership was a bona fide sale for full and adequate consideration, the court said no:

> Austin formed KPLP with the help of his estate lawyer but without the involvement of his sons, who were each to be 24.5-percent owners through trusts and who each signed the KPLP agreement. Austin alone decided which of his and Edna's assets would be contributed to KPLP, the terms of the KPLP agreement, that the living trust would receive management fees as general partner, and whether the limited partners would receive any distributions. In his testimony, Dennis was unfamiliar with the terms of the KPLP agreement. He thought its terms were followed at all times but was unsure how the management fees were to be determined. Gary Korby, one of Dennis's brothers, testified that he was not aware that his father received management fees from KPLP, that he was not represented in the formation of KPLP, and that he did not know how he acquired his interest in KPLP, whether by gift or otherwise. He also testified that although he signed the KPLP agreement in 1994, the first time his father explained the partnership to him and gave him a chance to ask questions about it was at a partnership meeting in February 1995. Dennis' other two brothers did not testify at trial, but the parties stipulated that their testimony would echo Gary's testimony. These facts indicate that none of Austin's and Edna's four sons was involved in the formation of the partnership or the drafting of the KPLP agreement. Austin essentially stood on all sides of the partnership's formation and approved the provisions of the KPLP agreement without negotiation or input from the limited partners.
>
> The circumstances leading us to conclude above that the payments from KPLP to the living trust were not management fees also weigh against a conclusion that the sale of assets to KPLP was bona fide. The Korbys' use of KPLP income for

> basic living expenses is inconsistent with a finding of a bona fide transfer. By drafting the KPLP agreement to allow the living trust to determine the amounts of its purported fees as general partner and by making Dennis, with whom Austin had an implied agreement, his cotrustee, Austin ensured that he and Edna would be provided with sufficient income from the KPLP assets during their lifetimes.
>
> The estate argues that the creation of KPLP was bona fide because Austin and Edna created KPLP to protect the family from commercial and personal injury liability resulting from their bridge- building business, as well as liability arising from divorce. The estate points to provisions in the KPLP agreement that prevented any partner from unilaterally forcing a distribution of partnership property and restricted transfer of the limited partnership interests. However, the estate has not shown that the terms of the KPLP agreement would prevent a creditor of a partner from obtaining that partner's KPLP interest in an involuntary transfer. The limited protection KPLP gave the family and the other evidence in the record lead us to believe that credit protection was not a significant reason for forming KPLP; rather, Austin and Edna formed KPLP in order to make a testamentary transfer of their assets to their sons at a discounted value while still having access to the income from those assets for their lifetime. Instead of retaining assets sufficient to provide the income they would need as their medical expenses grew, Austin and Edna used KPLP in an attempt to insulate all of their income-producing assets from the estate tax. As a result, we find that the transfer of Austin's and Edna's assets to KPLP was not a bona fide sale for full and adequate consideration. Therefore, section 2036(a)(1) applies to the KPLP assets that were contributed by Austin and Edna. Given this conclusion, we need not address respondent's argument for inclusion under sections 2036(a)(2) and 2038.

In Estate of Virginia A. Bigelow v. Commissioner, T. C. Memo 2005-65, the Tax Court had no difficulty including the assets of a partnership in the decedent's estate when the primary asset was rental property, rents from which were used by the decedent to make loan payments, and after the transfer of the property to the partnership the decedent did not have enough income for living expenses absent the income from the partnership. The opinion states:

> 1. Whether There Was an Implied Agreement That Decedent Would Retain the Right to the Income From the Padaro Lane Property During Her Lifetime
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> The estate contends that there was no implied agreement for decedent to retain the right to income from the Padaro Lane property. We disagree. The Padaro Lane property was generating monthly rent of $3,500. The taxes and insurance on the property totaled $1,350. After the partnership was formed, decedent used $2,000 of the $2,150 net income from the rental of the Padaro Lane property to make monthly payments on the Great Western loan. After the AARP/Prudential residential care insurance policy expired in August 1995, decedent's expenses exceeded her income by $2,700. The partnership continued to make the $2,000 payments on the Great Western loan, and Mr. Bigelow transferred partnership funds to decedent's trust to support decedent. No distributions were made to any other partner before decedent's death. Section 2036 applies if a decedent retains the right to income from the property or if there was an implied agreement to that effect. Estate of Reichardt v. Commissioner, supra at 153; Estate of Hillgren v. Commissioner, T.C. Memo. 2004-46; see Estate of Thompson v. Commissioner,

> supra at 375. Decedent's use of partnership income to replace the income lost because of the transfer of the Padaro Lane property to the partnership shows that there was an implied agreement between decedent and her children that she would retain the right to the income from the Padaro Lane property.
>
> 2. Whether There Was an Implied Agreement That Decedent Would Retain the Enjoyment of the Padaro Lane Property During Her Lifetime
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> The estate contends that there was no express or implied agreement for decedent to retain the enjoyment of the Padaro Lane property. We disagree. Enjoyment includes present economic benefits. Guynn v. United States, 437 F.2d 1148, 1150 (4th Cir. 1971); Estate of Reichardt v. Commissioner, supra at 151. After the transfer of the Padaro Lane property to Spindrift, the property continued to secure decedent's legal obligation to pay the $350,000 Great Western Bank loan and the $100,000 Union Bank line of credit. Thus, decedent retained the economic benefit of ownership of the Padaro Lane property after it was transferred to the partnership.
>
> We conclude that there was an implied agreement between decedent and her children that she would retain for her life the present economic benefit of the Padaro Lane property

With respect to whether the transfer to the partnership was a bona fide sale for full and adequate consideration the court placed great weight on the decedent's inability to pay her expenses after the transfer:

> Before the Padaro Lane property was transferred to the partnership, decedent met her financial obligations.5 After the transfer, decedent no longer received rent from the property, but she remained liable for both the Great Western Bank loan and the Union Bank line of credit. The transfer of the Padaro Lane property to the partnership left decedent unable to meet her financial obligations because her reduced income of $5,800 was insufficient to pay her reduced expenses of $7,000.
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> * * *
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> The estate points out that formalities to establish the partnership were met and contends that any lapses in complying with partnership formalities after formation were unimportant. We disagree. Spindrift did not properly maintain records of partnership capital or the partners' capital accounts. The balance sheets included in the 1995-97 returns incorrectly show the Great Western Bank loan as a liability of the partnership. None of the partners' Schedules K-1 accurately reflect the partners' capital accounts; e.g., decedent's capital account reported on the Schedules K-1 never reflects decedent's trust's contribution of the Padaro Lane property. The Bigelows did not comply with all of the terms of the partnership agreement. These facts suggest that the sale was not in good faith.

Judge Colvin rejected all arguments that the asset protection or continuity of management were real reasons for the formation of the partnership. Further, the court stated that faciliating gifts was not sufficient in this context to make a transfer bona fide for full and adequate consideration. The court specifically rejected the taxpayer's attempt to rely on <u>Kimbell</u>.

Kimbell v. U.S., 371 F.3d 257 (5th Cir. 2004), is an important loss for the government. The Fifth Circuit reversed the District Court directly on 2036 grounds. The District Court had held that section 2036(a)(1) would apply to assets in a partnership where the decedent was a 99% limited partner and the partnership agreement allowed a 70% partner to remove and replace the general partner. The opinion states:

> Plaintiff argues that Decedent's transfer of assets to the Partnership was a bona fide sale for an adequate and full consideration in money or money's worth. The Tax Court has explained, and this Court agrees, that "applicability of the [bona fide sale] exception rests on two requirements: (1) [a] bona fide sale, meaning an arm's-length transaction, and (2) adequate and full consideration." Harper, T.C.M. (RIA) 2002-121, *21.
>
> In the instant case, Decedent's transfer fails both requirements. Plaintiff has produced no credible evidence that the formation of the Partnership was the product of an arm's length transaction, i.e. a transaction "between two parties who are not related or not on close terms and who are presumed to have roughly equal bargaining power." Black's Law Dictionary 103 (7th ed. 1999). Indeed, one cannot even find two parties, much less two parties conducting an arm's length negotiation leading to a "bona fide sale". See Mollenberg's Estate v. Commissioner, 173 F.2d 698, 701 (2d Cir. 1949)(quoted in Harper, T.C.M. (RIA) 2002-121, *21)(defining a 'sale' as "an exchange resulting from a bargain"). Ownership interests in the Partnership are held by two entities: 99% by the Trust which was wholly-owned by Decedent, and 1% by the LLC which was 50% owned by the Trust. Therefore, Decedent not only "stood on both sides of the transaction," but, for all intensive purposes, was both sides of the transaction. Harper, T.C.M. (RIA) 2002-121, *21 (noting that "it would be an oxymoron to say that one can engage in an arm's length transaction with oneself").
>
> Moreover, even if one assumes the Partnership was the result of "a bona fide sale," Plaintiff has failed to establish that the Decedent received "adequate and full consideration" for the sale. While "adequate and full consideration" is not defined in the Code, Wheeler v. U.S., 116 F.3d 749, 754-55 (5th Cir. 1997), this Court agrees with the Tax Court that the meaning of "adequate and full consideration" does not include paper transactions such as the one at issue in the current case. The Decedent, through the Trust, contributed 99% of the capital for the Partnership and in return received a 99% interest in the partnership. Decedent received no consideration other than the interest in the Partnership. Plaintiff, before becoming the general partner of the Partnership, was already managing both the Trust, from where 99% of the assets of the Partnership came and the LLC from where the other 1% came (of which 0.5% were from the Trust). Nothing appears to have changed.

The taxpayer also argued that the fiduciary duty of the general partner precludes the application of section 2036:

> Plaintiff contends that Decedent did not have the power to take over the partnership because she had fiduciary duties. Plaintiff makes much of a Supreme Court case, U.S. v. Byrum, 408 U.S. 125 (1972), in which the Court held that §§2036 did not apply to a decedent who retained voting interest in several corporations. However, Byrum, is not only distinguishable on its facts from our case, but was expressly overruled by Congressional enactment of §§2036(b)

> which states that "the retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation shall be considered to be a retention of the enjoyment of the transferred property." Moreover, section 2.95 of the Partnership Agreement states: "The General Partner will not owe a fiduciary duty to the Partnership or to any Partner."6 If Decedent, at any time, could remove the general partner and herself become general partner, then, by the terms of the Agreement, she would not owe a fiduciary duty to the other Partners, who, in any case, own only a minuscule share of the Partnership. Assuming such fiduciary duties exist, to whom does a party which owns 99.% of the Partnership owe them? The fiduciary argument falls flat.

The Fifth Circuit approached the case differently, finding that section 2036(a) did not apply ab initio. The opinion summarizes section 2036(a) like this:

> The statute provides two exceptions that will allow a transfer to escape the operation of § 2036(a). First, if the transfer is a bona fide sale for full and adequate consideration, then § 2036(a) does not apply. See Treas. Reg. §§ 20.2036-1(a), 20.2043- 1(1)(as amended in 1960). If the transfer is not a bona fide sale for full and adequate consideration, then the transfer may still be excluded from the estate of the decedent under the second exception, if the decedent did not retain either the (1) possession, enjoyment or rights to the transferred property, or (2) the right to designate the persons who would possess or enjoy the transferred property. Estate of Stone v. Comm'r, 86 T.C.M. (CCH) 551, 578 [TC Memo 2003-309] (T.C. 2003); 26 U.S.C. § 2036(a).

The Fifth Circuit found that the first exception applied here. The opinion states:

> In summary, what is required for the transfer by Mrs. Kimbell to the Partnership to qualify as a bona fide sale is that it be a sale in which the decedent/transferor actually parted with her interest in the assets transferred and the partnership/transferee actually parted with the partnership interest issued in exchange. In order for the sale to be for adequate and full consideration, the exchange of assets for partnership interests must be roughly equivalent so the transfer does not deplete the estate. In addition, when the transaction is between family members, it is subject to heightened scrutiny to insure that the sale is not a sham transaction or disguised gift. The scrutiny is limited to the examination of objective facts that would confirm or deny the taxpayer's assertion that the transaction is bona fide or genuine. We now turn to the application of these principles to today's case.

The first question was whether the transfer was for "full and adequate consideration." The language quoted above -- that a sale is for full and adequate consideration -- suggested a problem for the taxpayer. However, the court applied a different test:

> The district court found that the exchange of a limited partnership interest for the assets Mrs. Kimbell transferred to the Partnership was not a bona fide sale for adequate and full consideration. It did not separately analyze the two requirements. Rather it concluded that Mrs. Kimbell's contribution of more than 99% of the assets into the Partnership to be managed (as they were before the transfer) by her son was nothing more than a recycling of value and the interest in the Partnership Mrs. Kimbell received not a transfer of consideration. The

government adopted that position and argues in addition that it is inconsistent for the estate to assert, on one hand, that the value of Mrs. Kimbell's interest in the Partnership is worth only 50% of the assets she transferred (as discounted for lack of control and marketability), and on the other hand claim that the Partnership interest Mrs. Kimbell received in exchange for the assets transferred was adequate and full consideration for the transfer.

* * *

We would only add to the Tax Court's rejection of the government's inconsistency argument that it is a classic mixing of apples and oranges: The government is attempting to equate the venerable "willing buyer-willing seller" test of fair market value (which applies when calculating gift or estate tax) with the proper test for adequate and full consideration under § 2036(a). This conflation misses the mark: The business decision to exchange cash or other assets for a transfer-restricted, non- managerial interest in a limited partnership involves financial considerations other than the purchaser's ability to turn right around and sell the newly acquired limited partnership interest for 100 cents on the dollar. Investors who acquire such interests do so with the expectation of realizing benefits such as management expertise, security and preservation of assets, capital appreciation and avoidance of personal liability. Thus there is nothing inconsistent in acknowledging, on the one hand, that the investor's dollars have acquired a limited partnership interest at arm's length for adequate and full consideration and, on the other hand, that the asset thus acquired has a present fair market value, i.e., immediate sale potential, of substantially less than the dollars just paid — a classic informed trade-off.

As this principle applies to wholly unrelated buyers and sellers of interests in limited partnerships, it must be equally true of buyers and sellers of such interests who happen to be related by blood or affinity, unless (1) the evidence demonstrates the absence of good faith, i.e., a sham transaction motivated solely by tax avoidance, or (2) Congress or the courts are ready to change long-held positions and establish a per se rule that related parties can never enter into arms-length transactions for adequate and full consideration — positions that none has shown any inclination to assume. Certainly, close scrutiny must be applied when the parties are related, but close scrutiny is not synonymous with automatic proscription or impossibility vel non.

The proper focus therefore on whether a transfer to a partnership is for adequate and full consideration is: (1) whether the interests credited to each of the partners was proportionate to the fair market value of the assets each partner contributed to the partnership, (2) whether the assets contributed by each partner to the partnership were properly credited to the respective capital accounts of the partners, and (3) whether on termination or dissolution of the partnership the partners were entitled to distributions from the partnership in amounts equal to their respective capital accounts. Id. at 580. The answer to each of these questions in this case is yes. Mrs. Kimbell received a partnership interest that was proportionate to the assets she contributed to the Partnership. There is no question raised as to whether her partnership account was properly credited with the assets she contributed. Also, on termination and liquidation of the Partnership, the Partnership Agreement requires distribution to the Partners according to their capital account balances.

Thus the court is clear: if a proper allocation to capital accounts is made there is full and adequate consideration. The court next considered whether the creation of the partnership was a bona fide sale. Recall that it was formed by her son as attorney-in-fact two months before the 96 year old decedent died. The opinion states:

> Our review of the record reveals that the taxpayer established the following objective facts (uncontroverted by the government) that would support their position that the transfer to the Partnership was a bona fide sale:
>
> > (1) Mrs. Kimbell retained sufficient assets outside the Partnership for her own support and there was no commingling of Partnership and her personal assets. See Estate of Strangi, 85 T.C.M. at 1338–39; Estate of Harper, 83 T.C.M. at 1650.
> >
> > (2) Partnership formalities were satisfied and the assets contributed to the Partnership were actually assigned to the Partnership. Id.
> >
> > (3) The assets contributed to the Partnership included working interests in oil and gas properties which do require active management. A working interest in an oil and gas lease is a cost-bearing operating interest in the property. Lowe, Oil and Gas Law in a Nutshell 40 (2003). The owners of the working interest have the exclusive right to exploit the minerals on the land. Williams & Meyers, Manual of Oil and Gas Terms 1207, 11th edition (2000). Nonoperating working interest owners are called upon to pay their share of operating expenses and to make elections whether to participate in drilling operations or various phases thereof. Lowe at 387–92. A royalty interest, in contrast, is a passive right to receive a share of production, if and when there is production, free of costs. Manual of Oil & Gas Terms at 964. At formation, \$438,000 of approximately \$2.5 million in assets were oil and gas properties. Approximately 71% of the oil and gas interests were working interests. Strangi, 85 T.C.M. at 1344; Thompson, 84 T.C.M at 388.
> >
> > (4) David Kimbell and Michael Elyea advanced several credible and unchallenged non-tax business reasons for the formation of the Partnership that could not be accomplished via Mrs. Kimbell's Trust. Harper, 83 T.C.M. at 1654; Thompson, 84 T.C.M. at 389.
>
> Michael Elyea, Mrs. Kimbell's business advisor, testified as follows regarding the business strategy for forming the Partnership. He stated that he and Mrs. Kimbell first discussed placing the assets in a limited partnership around the same time the living trust was formed in the early 1990's. Although some business strategies were accomplished by the trust, others were not. Specifically, a living trust did not provide legal protection from creditors as a limited partnership would. That protection was viewed as essential by Mr. Elyea and Mrs. Kimbell because she was investing as a working interest owner in oil and gas properties and could be personally liable for any environmental issues that arose in the operation of those properties. Mr. Elyea also stated that Mrs. Kimbell wanted the oil and gas operations to continue beyond her lifetime and they felt that by putting the assets in a limited partnership, they could keep the pool of capital together in one entity that would be enhanced over time rather than subdivided by distributions to subsequent generations. Keeping the assets in one pool, under one management would reduce administrative costs by keeping

> all accounting functions together. The partnership would also avoid costs of recording transfers of oil and gas properties as the property was passed from generation to generation. Mrs. Kimbell wanted to keep the asset in an entity that would preserve the property as separate property of her descendants. The family had faced that issue during the divorce of one of Mrs. Kimbell's grandsons. The partnership also served the purpose of setting up the management of the assets if something should happen to her son, which was a concern as he had experienced some heart problems and had undergone a serious surgery. The partnership agreement provided that all disputes be resolved through mediation or arbitration to avoid interfamily litigation if disputes should arise. This statement of reasons is supported by the recitation of purposes in the formation documents of the Partnership (which the government and the district court selectively excerpt) and the deposition testimony of Mrs. Kimbell's son. More to the point, the stated reasons for the formation of the Partnership are confirmed by objective facts, many of which relate to the rights and responsibilities associated with investments in oil and gas investments.

The partnership owned a substantial portion of the decedent's assets which would not be sheltered from creditors created by the oil and gas interests, and, of course, the decedent had presumably lived with the liability for many years already. Thus the true relevance of the oil and gas interest -- 11% working interests, 4% royalty interests, of the total partnership -- may be questioned.

The court rejected the need for others to make substantial contributions, or for investments to change after the partnerships were formed:

> The government contends that one fact pointing toward a conclusion that Mrs. Kimbell's transfer to the Partnership was not a bona fide sale is the de minimis contribution to the partnership made by the other partners. Mrs. Kimbell's son and his wife contributed approximately $20,000 of the $2.4 million in assets in the Partnership. This argument amounts to a restatement of the government's recycling of value argument and does not justify treating the transaction as a sham. In addition, we know of no principle of partnership law that would require the minority partner to own a minimum percentage interest in the partnership for the entity to be legitimate and its transfers bona fide. The government also points out that the management of the Partnership assets did not change as a result of the transaction. Prior to the formation of the Partnership, David Kimbell managed Mrs. Kimbell's assets in the Trust. He continued to manage the assets once they were transferred to the Partnership. However, the important fact is that David Kimbell contributed his management expertise to the Partnership after its formation. Given the business reasons established above for the change in business form, the fact that David Kimbell performed the same services for the assets in the Trust is irrelevant.

Interestingly, the court also rejected the direct inclusion of one-half of 1% of the underlying partnership assets through the decedent's 50% ownership of an LLC which was the 1% general partner. In what would appear to be a holding clearly contrary to Judge Cohen's opinion in <u>Strangi</u>, the court stated:

> The district court's application of § 2036(a) to the LLC transfer was erroneous. Even if the transfer did not constitute a bona fide sale for full and adequate consideration, Mrs. Kimbell did not retain sufficient control of the assets

> transferred to the LLC to make her transfer subject to § 2036(a). Mrs. Kimbell's interest in the LLC was only a 50% interest, and her son had sole management powers over the LLC. Thus, Mrs. Kimbell did not retain the right to enjoy or designate who would enjoy the LLC property. Accordingly, we vacate the ruling of the district court on this issue.

The Third Circuit disagreed with the Fifth Circuit's interpretation of "full and adequate consideration" in Turner v. Commissioner of Internal Revenue, 382 F.3d 367 (3rd Cir. 2004) (was Estate of Theodore Thompson below). The Tax Court had applied section 2036(a)(1) to include the partnership assets. The court agreed stating:

> After reviewing the record evidence, we see no clear error in the Tax Court's finding of an implied agreement between decedent and his family that decedent would "continue[ ] to be the principal economic beneficiary of the contributed property" and retain enjoyment of the transferred property sufficient to trigger § 2036(a)(1). *Thompson*, 84 T.C.M. at 387. Decedent transferred 95% of his assets to the family partnerships when he was ninety-five years old. As the Tax Court correctly found, decedent did not retain sufficient assets to support himself for the remainder of his life, as calculated at the time of transfer. [FN14] This fact supports the inference that decedent had "an implied understanding that his children would agree to his requests for money from the assets he contributed to the partnerships, and that they would do so for as long as he lived." *Id.* at 387. The record reflects Betsy and George Turner anticipated and prepared for this eventuality by seeking assurances from financial advisors that decedent would be able to withdraw assets from the partnerships to make cash gifts to the family. [FN15] Moreover, when decedent's remaining assets eventually ran low, Betsy Turner secured approval from the limited partnership to provide decedent with an "infusion" to cover his expenses.

The court rejected the exception for transfers which are bona fide sales for full and adequate consideration. The court cited the Tax Court decisions in Harper and Strangi and agreed with the "recycling" theory. The opinion states:

> In the case of the Thompson Partnership, the only "active operations" claimed by the estate involved leasing the Norwood, Colorado ranch back to its contributing partner and former resident, Robert Thompson, for an annual fee of $12,000. The Norwood ranch was not otherwise operated as an income producing business, either before or after Robert Thompson contributed the property to the partnership. Robert Thompson apparently generated some income from the sale of mules raised on the property, but income from these sales went to Robert directly and not to the partnership. Nevertheless, the Thompson Partnership paid an annual "management fee" ranging between $23,625 and $47,500 to the Thompson Corporation, which in turn paid Robert Thompson an annual salary of $32,001. We see no error in the Tax Court's finding this putative business arrangement amounted to no more than a contrivance, and did not constitute the type of legitimate business operations that might provide a substantive non-tax benefit for transferring assets to the Thompson Partnership.
>
> The operations of the Turner Partnership were more extensive, but still fail to provide sufficient objective indicia of a legitimate business operation. Although the Turner Partnership made numerous loans to Betsy Turner's children and grandchildren, this lending activity appears largely testamentary in practice. Loans were not made to anyone outside the extended Turner family, interest payments were often late or never paid, and the partnership took no enforcement action against delinquent debtors. We agree with the Tax Court that these lending activities "lacked

> any semblance of business transactions," and were "testamentary in nature, using decedent's money as a source of financing for the needs of individual family members, not for business purposes." Thompson, 84 T.C.M. at 388. Furthermore, the partners amended the Turner Partnership agreement, retroactive to April 23, 1993, to allocate all gains and losses from, and distribution of real estate contributed to the partnership, to the individual contributing partner. Aside from decedent's securities, the Turner Partnership consisted primarily of real estate assets. Directing all income derived from the partnership's real estate assets to the contributing partner-including any appreciation realized in the sale of such assets [FN21]-denied decedent any non-tax benefit potentially derived from the assets collected in the partnership.
>
> The Turner Partnership's $186,000 investment in the Lewisville Properties gives us some pause, but ultimately does not alter our conclusion. Unlike the other activities of the Turner and Thompson Partnerships, this investment seems to qualify as a legitimate business transaction with a third-party. [FN22] However, based on the record evidence in this case, we conclude that any legitimizing effect of the Turner Partnership's investment in the Lewisville Properties is overwhelmed by the testamentary nature of the transfer and subsequent operation of the partnership.
>
> In addition to the lack of legitimate business operations, the form of the transferred assets-predominately marketable securities-is significant to our assessment of the potential non-tax benefits available to decedent as a result of the transfer. Other than favorable estate tax treatment resulting from the change in form, it is difficult to see what benefit could be derived from holding an untraded portfolio of securities in this family limited partnership with no ongoing business operations. Compare Church v. United States, No. SA-97-CA-0774-OG, 2000 WL 206374, 2000 U.S. Dist. LEXIS 714 (W.D. Tex. Jan 18, 2000), aff'd without published opinion, 268 F.3d 1063 (5th Cir.2001) (applying § 2036(a) exception to assets transferred to a limited partnership that consolidated undivided ownership interests and administration of a family ranching business); Estate of Stone v. Comm'r, T.C. Memo 2003- 309; 86 T.C.M. (CCH) 551 (2003), 2003 Tax Ct. Memo LEXIS 312, (applying § 2036(a) exception to assets transferred to family partnerships operated as going concern businesses in order to transfer management of businesses to children); Kimbell v. United States, 371 F.3d 257, 267-68 (5th Cir.2004) (applying § 2036(a) exception to working oil and gas interests transferred to a family partnership to provide, among other things, centralized management and protection from personal environmental liabilities). The *381 form of assets transferred supports our conclusion there was no transfer for consideration within the meaning of § 2036(a).

The Third Circuit also concluded that the transfers of assets to the partnership were not bona fide sales. The court did not require an arms-length transaction between the transferor and transferee but did require that it be made in good faith:

> However, while a "bona fide sale" does not necessarily require an "arm's length transaction," it still must be made in good faith. See 26 C.F.R. § 20.2043-1(a). A "good faith" transfer to a family limited partnership must provide the transferor some potential for benefit other than the potential estate tax advantages that might result from holding assets in the partnership form. Even when all the "i's are dotted and t's are crossed," a transaction motivated solely by tax planning and with "no business or corporate purpose ... is nothing more than a contrivance." Gregory v. Helvering, 293 U.S. 465, 469, 55 S.Ct. 266, 79 L.Ed. 596 (1935). "To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." Id. As discussed in the context of "adequate and full consideration," objective indicia that the partnership operates a legitimate business may provide a sufficient factual basis for finding a good faith

> transfer. But if there is no discernable purpose or benefit for the transfer other than estate tax savings, the sale is not "bona fide" within the meaning of § 2036. See, e.g., id. (ignoring a transaction for estate tax purposes after finding "no business or corporate purpose" for the transaction); compare Kimbell, 371 F.3d at 267 (finding a "bona fide sale" where the transaction was entered into for "substantial business and other non-tax reasons").

On the precise question of whether a transferor received full and adequate consideration when transferring assets to a partnership and receiving partnership interests which were discountable - - i.e. is allocation to the proper capital accounts sufficient to constitute full and adequate consideration - - the majority opinion was not perfectly clear stating:

> In one sense, claiming an estate tax discount on assets received in exchange for an inter vivos transfer should defeat the § 2036(a) exception outright. If assets are transferred inter vivos in exchange for other assets of lesser value, it seems reasonable to conclude there is no transfer for "adequate and full consideration" because the decedent has not replenished the estate with other assets of equal value. See Wheeler v. United States, 116 F.3d 749, 762 (5th Cir.1997) ("[U]nless a transfer that depletes the transferor's estate is joined with a transfer that augments the estate by a commensurate (monetary) amount, there is no 'adequate and full consideration' for the purposes of either the estate or gift tax.").
>
> That said, the Tax Court has held that the dissipation of value resulting from the transfer of marketable assets to a closely-held entity will not automatically constitute inadequate consideration for purposes of § 2036(a). See Harper, 83 T.C.M. at 1654 (noting partnership interests may constitute "adequate and full consideration" if there is also a "potential [for] intangibles stemming from pooling for joint enterprise"); Stone, 86 T.C.M. at 581 (concluding the lack of marketability discount applied to limited partnership interests does not, on its own, result in inadequate consideration for purposes of § 2036).
>
> Nonetheless, we believe this sort of dissipation of value in the estate tax context should trigger heightened scrutiny into the actual substance of the transaction. Where, as here, the transferee partnership does not operate a legitimate business, and the record demonstrates the valuation discount provides the sole benefit for converting liquid, marketable assets into illiquid partnership interests, there is no transfer for consideration within the meaning of § 2036(a).

A concurrence was perfectly clear on the point:

> The Commissioner correctly recognizes that Stone is inconsistent with his position here and the estate understandably relies on Stone. I reject Stone on the quoted point as the Commissioner's position in no way reads the exception out of section 2036(a) and the Tax Court does not explain *387 why it does. [FN24] Rather, the Commissioner seeks to apply the exception precisely as written as his position should not be applied in ordinary commercial circumstances even though the decedent may be said to have enjoyed the property until his death.
>
>> FN24. In Kimbell v. United States, 371 F.3d 257, 265-66 (5th Cir.2004), the court quoted the above language from Stone with approval and went on to point out that:
>>
>>> We would only add to the Tax Court's rejection of the government's inconsistency argument that it is a classic mixing of

> apples and oranges: The government is attempting to equate the venerable 'willing buyer-willing seller' test of fair market value (which applies when calculating gift or estate tax) with the proper test for adequate and full consideration under § 2036(a). This conflation misses the mark: The business decision to exchange cash or other assets for a transfer-restricted, non-managerial interest in a limited partnership involves financial considerations other than the purchaser's ability to turn right around and sell the newly acquired limited partnership interest for 100 cents on the dollar.
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> Investors who acquire such interests do so with the expectation of realizing benefits such as management expertise, security and preservation of assets, capital appreciation and avoidance of personal liability. Thus there is nothing inconsistent in acknowledging, on the one hand, that the investor's dollars have acquired a limited partnership interest at arm's length for adequate and full consideration and, on the other hand, that the asset thus acquired has a present fair market value, i.e., immediate sale potential, of substantially less than the dollars just paid--a classic informed trade-off.

I believe, however, that Kimbell does not take into account that to avoid the recapture provision of section 2036(a) the property transferred must be "replaced by property of equal value that could be exposed to inclusion in the decedent's gross estate" D'Ambrosio, 101 F.3d at 313 (quoting Frothingham, 60 T.C. at 216 (omitting emphasis)), on a "money or money's worth" basis.

In March, 2005 the Tax Court attempted to bring some order to its section 2036 jurisprudence in the family partnership context, in Estate of Wayne C. Bongard v. Commissioner, 124 T. C. No. 8 (2005), a reviewed opinion. Judge Goeke (who decided Korby above) authored the majority opinion signed by nine judges. Two judges concurred in a separate opinion, one wrote separately to concur and dissent, and three wrote separately to concur and dissent.

Mr. Bongard transferred shares of stock in a closely-held company (Empak, Inc.) to an irrevocable trust (ISA Trust) in 1986. He retained a power to persuade the trustees to follow his wishes, at least in part, because at various times he suggested the trustees make certain stock distributions and those suggestions were followed. The stock was subsequently redeemed by the company.

In the mid-1990s the family and advisors decided that all of the family's stock in Empak should be combined so that Empak could sell stock publicly or privately in order to raise capital. So, Mr. Bongard and the trust capitalized WCB Holdings, LLC by transferring to it their respective shares in Empak. In exchange, Mr. Bongard and the trust received interests in each of four classes of stock: Class A governance, Class A financial, Class B governance, and Class B financial. Mr. Bongard received 86.39% of each class and the trust received 13.61% of each class. The Class A governance units had effective control over the LLC.

Within days of contributing the Empak stock to the LLC, Mr. Bongard contributed his Class B governance and Class B financial units to Bongard Family Limited Partnership (BFLP) in exchange for a 99% limited partnership interest. The trust received a 1% general partnership interest in BFLP. Mr. Bongard also gave portions of his Class A governance interests to trusts for his descendants and to a lifetime QTIP for his wife.

In early 1998 Mr. Bongard wanted cash to go to his four children to see how they would handle the funds. Empak redeemed some shares from the LLC and the LLC redeemed some units from the trust and the trustees of the trust made distributions of $100,000 each to the four children. On November 16, 1998 Mr. Bongard, age 57, died unexpectedly.

At issue before the Tax Court was whether the Empak stock should be included directly in Mr. Bongard's estate, and whether the LLC interests should be included in Mr. Bongard's estate. Stated another way, did section 2036 apply to the transfers into the LLC or to the transfers into BFLP. The Tax Court applied section 2036 to the transfers to the partnership but not to the LLC. In each analysis, the central question was whether the funding of the entities avoided section 2036 by reason of being a bona fide sale for full and adequate consideration.

First, with respect to the transfer of Empak stock to the WCB Holdings, LLC, the court stated that the transfer was a bona fide sale because there were legitimate non-tax reasons for creating the LLC:

> It is axiomatic that intrafamily transactions are subjected to a higher level of scrutiny, but this heightened scrutiny is not tantamount to an absolute bar. In that connection, we have already concluded that decedent and ISA Trust had mutual legitimate and significant nontax reasons for forming WCB Holdings. In addition, both decedent and ISA Trust received interests in WCB Holdings proportionate to the number of shares transferred. We believe that had this transaction occurred between two unrelated parties the majority interest holder in Empak would have received similar powers to those the decedent received via WCB Holdings's member control agreement. An important purpose for creating WCB Holdings was to position Empak for a corporate liquidity event, and the record does not contain any credible evidence that unrelated parties would not have agreed to the same terms and conditions. Given these facts, we cannot hold that the terms of the transaction differed from those of two unrelated parties negotiating at arm's length.
>
> Respondent's final argument is that the formation of WCB Holdings was not a bona fide sale because there was not a true pooling of assets. WCB Holdings's purpose was to pool the Bongard family's Empak stock within a single entity, which decedent and ISA Trust satisfied through their respective contributions. WCB Holdings's creation was part of a much grander plan, to attract potential investors or to stimulate a corporate liquidity event to facilitate Empak's growth. Moreover, when WCB Holdings was capitalized, the members' capital accounts were properly credited and maintained, WCB Holdings's funds were not commingled with decedent's, and all distributions during decedent's life were pro rata. The amalgamation of these facts evinces that this transaction resulted in a true pooling of assets.

The majority also found that the transfer was for full and adequate consideration because Mr. Bongard's ownership of 86.31% of the Class A governance units gave him practical control over the LLC. Thus, there was no reason Mr. Bongard should have received a "control premium" when he gave his Empak stock to the LLC.

On the other hand, the court found no legitimate, non-tax purpose for the limited partnership. The estate argued that the partnership was needed to allow gifts to be made, including a gift to Mrs. Bongard, for asset protection, as a trust substitute, and to help manage the partnership assets. The court found that Mr. Bongard made gifts after he formed the partnership but did not give away partnership interests other than to Mrs. Bongard. The estate argued that the gift of partnership units to her supported a general non-tax reason for the partnership but the court found that the decedent needed to give some assets to Mrs. Bongard in connection with a postnuptial agreement and he used the partnership interest because that is where the assets were. Further, Mr. Bongard made gifts to trusts after the partnership was formed and the partnership never actually managed the LLC interests it owned - - it did not try to diversify, for instance.

The court having failed to apply the bona fide sale for full and adequate consideration exception to section 2036 with respect to the transfer of LLC interests to the partnership, the next issue was whether Mr. Bongard retained an interest in the partnership. The court found that because Mr. Bongard controlled whether the partnership could sell its sole asset - - the LLC interests - - into something liquid he exercised "practical control" over the partnership. The opinion states:

> The decedent did not need the membership interest in WCB Holdings class B shares to continue his lifestyle. However, decedent retained ownership of more than 91 percent of his BFLP interest and did not make gifts of such interest prior to his death. More importantly, decedent controlled whether BFLP could transform its sole asset, the class B WCB Holdings membership units, into a liquid asset. Decedent as CEO and sole member of Empak's board of directors determined when Empak redeemed its stock in each of the seven instances of redemptions prior to his death, including the last redemption of about $750,000 worth of Empak stock in 1998 after WCB Holdings was formed. None of the seven redemptions reduced the membership units owned by BFLP. In order for BFLP to be able to diversify or take any steps other than simply holding the class B membership units, decedent would have had to cause the membership units and the underlying Empak stock to be redeemed. He chose not to do this. By not redeeming the WCB membership units held by BFLP, decedent ensured that BFLP would not engage in asset management. Thereby, decedent exercised practical control over BFLP and limited its function to simply holding title to the class B membership units. Whether decedent caused the WCB membership units held by BFLP and the underlying Empak stock to be redeemed or not, his ability to decide whether that event would occur demonstrates the understanding of the parties involved that decedent retained the right to control the units transferred to BFLP.
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> The estate's argument that the general partner's fiduciary duties prevents a finding of an implied agreement is overcome by the lack of activity following BFLP's formation and BFLP's failure to perform any meaningful functions as an entity.12 We conclude that decedent's transfer to BFLP for a 99-percent

> ownership interest in the partnership did not alter his control of the WCB Holdings class B membership units transferred to BFLP. See Estate of Thompson v. Commissioner, 382 F.3d at 376-377 (finding "nothing beyond formal title changed in decedent's relationship to his assets" where the practical effect on his relationship to the transferred assets during decedent's life was minimal).

Judge Laro wrote a concurrence (Judge Marvel joined) in which he argued that a transfer to a partnership could not be for full and adequate consideration unless the value of the partnership units received on account of the transfer were equal in value to the assets transferred to the partnership. That is, if the funding of the partnership "depletes" the estate there is no full and adequate consideration. In short, the opinion would side with Thompson over Kimbell with respect to the meaning of full and adequate consideration.

Judge Halpern concurred and dissented. He disagreed with the majority to the extent the majority considered the motive of the transferor. Further, he argued for a gift on formation theory if the interests received back by the transferor were less than those transferred. Obviously, Judge Halpern would agree in substance with Judge Laro's understanding of full and adequate consideration, although perhaps not with his reasoning, but in any event would go further. He agreed with the result that the Empak stock should not be included directly in Mr. Bongard's estate.

Judge Chiechi also concurred and dissented, joined by Judges Wells and Foley. These judges rejected the notion that merely because there is no non-tax reason for the formation of the partnership that means Mr. Bongard retained beneficial enjoyment of the assets transferred to the partnership. The opinion states:

> The majority opinion's rationale is factually, logically, and legally flawed.[8]
>
> The majority opinion's rationale is factually flawed for various reasons. One reason is that it concludes that decedent could have caused WCB Holdings to redeem the WCB Holdings class B membership units owned by BFLP. That conclusion is not supported by, and is contrary to, the following findings of fact of the majority opinion regarding the circumstances under which the chief manager of WCB Holdings (chief manager), who was decedent's son Mark Bongard, was required to obtain the approval of a majority of the WCB Holdings class A governance units before he could take certain actions on behalf of WCB Holdings:
>
>> the chief manager needed the approval of the members representing the majority of the class A governance units before he could issue additional membership units, lend, borrow, or commit WCB Holdings's funds in excess of $25,000, authorize capital expenditures in excess of $10,000, sell any of WCB Holdings's assets, including its Empak stock, worth over $10,000 in any twelve month period, or vote any securities, including its Empak stock, owned by WCB Holdings.
>
> Majority op. p. 14; emphasis added.

After decedent funded, by gift, on March 15, 1997, the Children's Trust, the Grandchildren's Trust, and the QTIP Trust, each with certain class A governance units and certain class A financial units in WCB Holdings, decedent no longer owned a majority of the class A governance units in WCB Holdings, the only voting units in WCB Holdings. Thus, decedent could not have approved, and certainly could not have required, that the chief manager commit any of WCB Holdings's funds in excess of $25,000 for the purpose of redeeming the WCB Holdings class B membership interests owned by BFLP. In addition, decedent could not have approved, and certainly could not have required, that the chief manager sell to Empak, through a redemption by Empak, Empak stock owned by WCB Holdings worth over $10,000 in any 12-month period.

Another factual flaw in the majority opinion's rationale relates to the conclusion that decedent had the ability to cause Empak to redeem the Empak stock owned by WCB Holdings. That conclusion disregards not only the implications of the majority opinion's finding that decedent and ISA Trust transferred their respective shares of Empak stock to WCB Holdings in order to position Empak for a liquidity event9 but also decedent's fiduciary duties as Empak's CEO and the sole member of its board of directors. Depleting Empak's assets by causing Empak to redeem the Empak stock owned by WCB Holdings in order to be able to diversify BFLP's assets through a redemption by WCB Holdings of the WCB Holdings class B membership units owned by BFLP would not have been consistent with the objective of positioning Empak for a liquidity event. Indeed, given that objective, it would have been, at best, bad business judgment on the part of decedent and a misconception by him of what was involved in positioning Empak for a liquidity event if he had decided to cause Empak to redeem the Empak stock owned by WCB Holdings in order to effect a diversification of BFLP's assets. Moreover, irrespective of the objective to position Empak for a liquidity event, any decision by decedent to deplete Empak's assets by causing Empak to redeem the Empak stock owned by WCB Holdings in order to effect such a diversification would have been, at worst, a breach by decedent of his fiduciary duties as Empak's CEO and the sole member of its board of directors. Any such decision by decedent might have been actionable by the stockholders of Empak, which, as of March 7, 1997, were: (1) WCB Holdings, a 90-percent stockholder whose class A governance unitholders, other than decedent,10 owned in the aggregate on and after March 15, 1997, a majority of the voting class A governance membership units in WCB Holdings; (2) Marubeni Corp. (MC), a 6-percent stockholder and a Japanese trading entity which had more than 700 subsidiaries and whose stock was listed on various international stock exchanges; and (3) Marubeni America Corp., a 4- percent stockholder and the U.S. sales and marketing subsidiary of MC. Cf. United States v. Byrum, 408 U.S. at 137-143. Thus, any ability of decedent to cause Empak to redeem the Empak stock owned by WCB Holdings was not unconstrained. Instead, any such ability was subject to the fiduciary duties imposed upon decedent as Empak's CEO and the sole member of its board of directors and to business and economic realities and variables over which he had little or no control and which he could ignore, but only at his peril. Cf. id.

The majority opinion's rationale contains other factual flaws. According to that rationale,

> decedent <u>controlled</u> whether BFLP could transform its sole asset, the class B WCB Holdings membership units, into a liquid asset. * * * In order for BFLP to be able to diversify or take any steps other than simply holding the class B membership units, decedent would have had

> to cause the membership units and the underlying Empak stock to be redeemed.11 He chose not to do this. By not redeeming the WCB membership units held by BFLP, decedent insured that BFLP would not engage in asset management. Thereby, decedent exercised practical control over BFLP and limited its function to simply holding title to the class B membership units. Whether decedent caused the WCB membership units held by BFLP and the underlying Empak stock to be redeemed or not, his ability to decide if that event would occur demonstrates the understanding of the parties involved that decedent retained the right to control the units transferred to BFLP.
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> * * * decedent's transfer to BFLP for a 99-percent ownership interest in the partnership did not alter his control of the WCB Holdings class B membership units transferred to BFLP. * * *

Majority op. pp. 57-59; emphasis added.

As is evident from the foregoing, the majority opinion establishes a "control" standard in applying section 2036(a)(1). However, the majority opinion never actually tells us what it means when it uses the terms "control" or "controlled" four times in the above-quoted excerpt.12 Nonetheless, under any commonly accepted meaning of those terms, it is factually incorrect for the majority opinion to conclude that "decedent controlled whether BFLP could transform its * * * class B WCB Holdings membership units * * * into a liquid asset * * * [,] exercised practical control over BFLP and * * * retained the right to control the units transferred to BFLP" and that "decedent's transfer to BFLP * * * did not alter his control of the WCB Holdings class B membership units transferred to BFLP." Majority op. pp. 57-58. After decedent and ISA Trust capitalized BFLP, which the majority opinion acknowledges was a validly created and existing partnership under Minnesota law, neither decedent nor ISA Trust had the same relationship to the respective WCB Holdings class B membership units that they transferred to BFLP. Decedent owned a limited partnership interest, and ISA Trust owned a general partnership interest, in BFLP. BFLP, in turn, owned such units transferred to it. Decedent, as a limited partner of BFLP, did not have, and did not exercise, control over BFLP, its assets, its activities, or its general partner, ISA Trust.

In addition to the factual flaws in the majority opinion's rationale, that rationale is logically flawed. It is a non sequitur for the majority opinion to conclude that, because of decedent's alleged ability to cause Empak to redeem the Empak stock owned by WCB Holdings and to cause WCB Holdings to redeem the WCB Holdings class B membership units owned by BFLP, "decedent controlled whether BFLP could transform its * * * class B WCB Holdings membership units * * * into a liquid asset * * * [and] exercised practical control over BFLP". Majority op. pp. 57-58. It also is a non sequitur for the majority opinion to conclude that any such alleged ability "demonstrates the understanding of the parties involved that decedent retained the right to control the units transferred to BFLP" and that his transfer to BFLP of his WCB Holdings class B membership units "did not alter his control" of such units. Majority op. pp. 58-59. The alleged ability of decedent to cause Empak to redeem the Empak stock owned by WCB Holdings and to cause WCB Holdings to redeem the WCB Holdings class B membership units owned by BFLP does not logically lead to any of the foregoing conclusions. Nor does any such alleged ability logically lead to the majority opinion's holding that "an implied agreement existed that allowed

> decedent to retain the enjoyment of the property held by BFLP." Majority op. p. 59.
>
> The majority opinion's rationale is also legally flawed. The language of section 2036(a)(1)13 "plainly contemplates retention of an attribute of the property transferred -- such as a right to income, use of the property itself, or a power of appointment with respect either to income or principal." United States v. Byrum, 408 U.S. at 149. Moreover, the term "enjoyment" used in section 2036(a)(1) is not a term or art; it "connote[s] substantial present economic benefit". Id. at 145. Decedent did not retain any attribute of the WCB Holdings class B membership units that he transferred to BFLP. Nor was decedent's alleged ability to cause Empak to redeem the Empak stock owned by WCB Holdings and to cause WCB Holdings to redeem the WCB Holdings class B membership units owned by BFLP a substantial present economic benefit of such units. Any such alleged ability was not a present benefit at all; it was "a speculative and contingent benefit which may or may not * * * [have been] realized."14 Id. at 150. There simply are no circumstances surrounding decedent's transfer of his WCB Holdings class B membership units to BFLP and no subsequent use of such units by decedent from which an implied agreement may be inferred that decedent retained the enjoyment of such units. See Estate of Reichardt v. Commissioner, 114 T.C. 144, 151 (2000). Section 2036(a)(1) rejects the majority opinion's holding that decedent retained the enjoyment of the WCB Holdings class B membership units that he transferred to BFLP.

With respect to Byrum the opinion states:

> The Supreme Court teaches us in United States v. Byrum, 408 U.S. 125 (1972), that section 2036(a)(1) (and section 2036(a)(2)) does not apply to a transfer by an individual to an irrevocable trust of shares of stock in certain corporations in which the transferor owned stock,17 where such ownership gave the transferor the ability, inter alia, to liquidate or merge such corporations and where the powers of the independent trustee of such trust were subject to the following rights expressly reserved by the transferor: (1) To vote the shares of unlisted stock held in the trust; (2) to disapprove the sale or transfer of any trust assets, including the shares transferred to the trust; (3) to approve investments and reinvestments; and (4) to remove the trustee and to designate another corporate trustee to serve as successor trustee. Id. at 126- 127.
>
> A fortiori, under the principles that the Supreme Court established in United States v. Byrum, supra, even if in the instant case decedent had the ability to cause Empak to redeem the Empak stock owned by WCB Holdings and to cause WCB Holdings to redeem the WCB Holdings class B membership units owned by BFLP, any such ability does not demonstrate, and did not result in, decedent's retention of the enjoyment of the WCB Holdings class B membership units that he transferred to BFLP within the meaning of section 2036(a)(1).18 In reaching a contrary holding, the majority opinion loses sight of, or chooses to disregard, the fact that any such ability is qualitatively different from the retention of the enjoyment (i.e., substantial present economic benefit, id. at 145) of the WCB Holdings class B units that he transferred to BFLP. See id. at 143, 145. In this connection, assuming arguendo the propriety of the majority opinion's conclusions that decedent had the ability to cause Empak to redeem the Empak stock owned by WCB Holdings and to cause WCB Holdings to redeem the WCB Holdings class B membership units owned by BFLP, any such ability does not demonstrate, and did not result in, the retention by decedent of the right to

> compel BFLP or ISA Trust, the general partner of BFLP, to distribute such units to or on behalf of decedent or otherwise to permit decedent to have substantial present economic benefit of such units.
>
> The majority opinion not only fails to apply section 2036(a)(1) and principles under section 2036(a) that the Supreme Count established in United States v. Byrum, supra, it also fails to apply principles established by Minnesota law regarding the fiduciary duties of the partners of partnerships and the trustees of trusts, which the majority opinion acknowledges exist.19 This is evidenced by the following passage from the majority opinion's rationale:
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>> The estate's argument that the general partner's fiduciary duties prevents a finding of an implied agreement is overcome by the lack of activity following BFLP's formation and BFLP's failure to perform any meaningful functions as an entity. We conclude that decedent's transfer to BFLP for a 99-percent ownership interest in the partnership did not alter his control of the WCB Holdings class B membership units transferred to BFLP. * * *

Judge Wherry has written the first post-Bongard Tax Court opinion dealing with section 2036 (a)(1) in Estate of Charles Porter Schutt v. Commissioner, T. C. Memo 2005-126. There two Delaware Business Trusts (Schutt I and Schutt II) were formed using assets from the decedent's revocable trust and various irrevocable trusts of which Wilmington Trust Company was trustee. Schutt I was funded with almost $68,000,000 in DuPont stock of which almost $31,000,000 came from the decedent's revocable trust and Schutt II was funded with almost $24,000,000 in Exxon stock of which about $11,000,000 was from the revocable trust. After the funding, the decedent owned about $30,000,000 in other assets (residences, other land, tangible personal property, and other investments). The decedent was trustee of the Delaware Business Trusts, and thus had effective control over the assets, and the net cash flow of the trusts was required to be, and was, distributed pro rata through the decedent's date of death.

The issue facing the court was whether the transfer of the stock to the Delaware Business Trusts was a bona fide sale for full and adequate consideration, in which case the trust interests would be valued (presumably) at a discount, or whether the DuPont and Exxon stock itself would be included in the decedent's estate. The court reviewed many conversations, memoranda, and letters among Mr. Dinneen, a CPA in charge of the Schutt family office, Mr. Sweeney, the Schutt's attorney in private practice, Mr. Howard, an officer of Wilmington Trust Company (WTC), and others. The court summarized its findings as to the purposes of the Delaware Business Trusts as follows:

> The estate's position is that Schutt I and II were "formed primarily to put into place an entity to perpetuate Mr. Schutt's buy and hold investment philosophy with respect to the DuPont and Exxon stock belonging both to Mr. Schutt and to the Wilmington Trust Company Trusts." In service of this objective, Schutt I and II were aimed at "the furtherance and protection of * * * [decedent's] family's wealth by providing for the centralized management of his family's holdings in duPont [sic] stock and Exxon stock during his lifetime and to prevent the improvident disposition of this stock during his lifetime and to the extent

possible after his death." The estate contends that the desired preservation of decedent's investment policy "could not be accomplished without the creation of Schutt I and Schutt II, as the WTC Trusts were scheduled to terminate at various intervals and the assets of those trusts would be distributed, free of trust, to their respective beneficiaries."

Respondent's argument to the contrary is summarized as follows:

> (1) it was not necessary to transfer stock from Mr. Schutt's revocable trust to the business trusts to perpetuate his investment philosophy; (2) the record establishes that obtaining valuation discounts for gift and estate tax purposes was the dominant, if not the sole, reason for forming the business trusts; and (3) in any event, Mr. Schutt's desire to perpetuate his investment philosophy was itself a testamentary motive. * * *

The totality of the record in this case, when viewed as a whole, supports the estate's position that a significant motive for decedent's creation of Schutt I and II was to perpetuate his buy and hold investment philosophy. That decedent was in fact a committed adherent to the buy and hold approach is undisputed. His longstanding concern with disposition of core stockholdings by his descendants is also well attested. Mr. Sweeney testified that decedent "would raise, at least annually and, quite often, more than annually, his concern about the ability of children or grandchildren or whoever it might be to sell principal rather than using the income from the principal". Mr. Dinneen likewise testified that decedent expressed concern about Schutt family members' selling of stock from "Back in the early seventies and on a regular basis from there on out."

The documentary record also furnishes at least a measure of objective support for the decedent's willingness to act based on these worries. In 1994, decedent declined to make annual exclusion gifts of limited partnership interests in the Schutt Family Limited Partnership to his daughter Sarah S. Harrison and her children. The estate attributes this decision to concern about the investment philosophy of these individuals, and the limited evidence does reflect 13 occasions on which DuPont or Exxon stock was sold by Harrison grandchildren from 1989 through 1997.

Further corroborating the bona fides of the professed intent underlying creation of Schutt I and II is the fact that formation of the business trusts did serve to advance this goal. Respondent's contention that the business trusts were unnecessary to perpetuate decedent's investment philosophy unduly emphasizes management of the assets held by the Revocable Trust and minimizes any focus on the considerable assets held in the WTC trusts. Respondent points out that, under the Revocable Trust indenture, decedent could control investment decisions pertaining to the assets until his death, at which time various successor trusts to be administered by his son and son-in-law would be funded. Respondent argues that the situation under the business trusts was functionally equivalent, with decedent as trustee setting investment philosophy during his lifetime, followed by his son and son-in-law as successor trustees.

However, by only considering the Revocable Trust assets in isolation, this analysis disregards more than half of the property involved in the business trusts. Decedent in effect used the assets of the Revocable Trust10 to enhance his ability to perpetuate a philosophy vis-a-vis the stock of the WTC trusts, such that

> none of the contributions should be disregarded in evaluating the practical implications of Schutt I and II. Mr. Howard testified that he did not believe he would have considered a proposal involving contribution only of the WTC trusts' assets to entities structured as were Schutt I and II, without decedent's willingness to place his own property alongside. As Mr. Howard explained: "it made real to me, certainly, when someone is willing to contribute that sum of money and tie it up the same way we were tying it up with respect to distributions, if not with respect to management, that this was something that he and the family, if they were willing to agree to it, felt strongly about." This importance of decedent's contributions to those negotiating on behalf of WTC, at least on a psychological level, reflects a critical interconnectedness between decedent's contributions and those of the WTC trusts.
>
> The effect of Schutt I and II on the assets of the WTC trusts shows that the business trusts advanced decedent's objectives in a meaningful way. Respondent's argument, however, to the extent that it takes into account the WTC assets, seeks to counter this conclusion by once again placing unwarranted emphasis on certain features or results of the structure to the exclusion of others. In discussing the alleged motive for involving the WTC trusts in the transaction, respondent states that "even if the decedent formed the business trusts to prevent his heirs from dissipating the family's wealth, this is itself a testamentary motive." More specifically, respondent dismisses the estate's contentions as follows:
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>> The decedent's testamentary motives are particularly evident in this case as it is clear that he was concerned about the dissipation of the family's wealth after his death as opposed to during his lifetime. While he was alive, he controlled the sale of stock held by his revocable trust. Similarly, as the direction or consent advisor to the bank trusts, none of the stock held by those entities could be sold without his consent. The only risk that assets held by the bank trusts could be sold without his consent was if one of his children predeceased him, thereby causing a distribution of a portion of the trust assets to that child's issue. Since his surviving children were all in good health when the business trusts were formed and the decedent was not, there is little doubt that the decedent was concerned about what would happen to the family's wealth after his death.
>
> The Court disagrees that decedent's motives may properly be dismissed, in the unique circumstances of this case, as merely testamentary. The record on the whole supports that decedent's greatest worry with respect to wealth dissipation centered on outright distribution of assets to the beneficiaries of the various WTC trusts. It is clear from the structures of the WTC trusts involved that outright distribution created the single largest risk to the perpetuation of a buy and hold philosophy, and testimony confirmed decedent's concern over a termination situation. Because none of the events that would trigger such a distribution turned on decedent's own death, to call the underlying motive testamentary is inappropriate.

The court was clearly concerned about deciding that the "perpetuation of a buy and hold investment strategy qualifies as a 'legitimate and significant non-tax reason'" within the meaning of Bongard. The opinion states:

> The Court of Appeals for the Third Circuit has in a similar vein suggested that the mere holding of an untraded portfolio of marketable securities weighs

negatively in the assessment of potential nontax benefits available as a result of a transfer to a family entity. Estate of Thompson v. Commissioner, 382 F.3d at 380. As a general premise, this Court has agreed with the Court of Appeals, particularly in cases where the securities are contributed almost exclusively by one person. See Estate of Strangi v. Commissioner, T.C. Memo. 2003-145; Estate of Harper v. Commissioner, T.C. Memo. 2002-121. In the unique circumstances of this case, however, a key difference exists in that decedent's primary concern was in perpetuating his philosophy vis-a-vis the stock of the WTC trusts in the event of a termination of one of those trusts. Here, by contributing stock in the Revocable Trust, decedent was able to achieve that aim with respect to securities of the WTC trusts even exceeding the value of his own contributions. In this unusual scenario, we cannot blindly apply the same analysis appropriate in cases implicating nothing more than traditional investment management considerations.

To summarize, the record reflects that decedent's desire to prevent sale of core holdings in the WTC trusts in the event of a distribution to beneficiaries was real, was a significant factor in motivating the creation of Schutt I and II, was appreciably advanced by formation of the business trusts, and was unrelated to tax ramifications. The Court is thus able to conclude in this case that Schutt I and II were formed for a legitimate and significant nontax purpose without further probing the parties' disagreement as to whether, in theory, an investment strategy premised on buy and hold should offer just as much justification for an entity premised thereon as a philosophy that focuses on active trading.

As regards other factors considered indicative of a bona fide sale, these too tend to support the estate's position. The contributed property was actually transferred to Schutt I and II in a timely manner. Entity and personal assets were not commingled. Decedent was not financially dependent on distributions from Schutt I and II, retaining sufficient assets outside of the business trusts amply to support his needs and lifestyle. Nor was decedent effectively standing on both sides of the transactions.

Concerning this latter point, it is respondent's position that "there were no 'arm's-length negotiations' between the decedent and the bank concerning any material matters affecting the formation and operation of the business trusts." Respondent maintains that WTC, while ostensibly an independent third party, simply represented the interests of decedent's children and grandchildren and that decedent dictated all material terms.

The Court, however, is unpersuaded by respondent's attempts to downplay the give-and-take reflected in the record. As detailed in the facts recounted above and the stipulated exhibits, WTC representatives thoroughly evaluated the business trust proposals, raised questions, offered suggestions, and made requests. Some of those suggestions or requests were accepted or acquiesced in; others were not. Such a scenario bears the earmarks of considered negotiations, not blind accommodation. There is no prerequisite that arm's-length bargaining be strictly adversarial or acrimonious.

Once the court found a bona fide sale, it was not difficult for it to determine that the decedent received full and adequate consideration for the transfer into the Trusts from the revocable trust because the capital accounts were properly credited and maintained. The court emphasized throughout the opinion what it termed the "unique circumstances of the case.

Where does that leave us with respect to family partnerships? Five general rules stand out.

> First, the form of the partnership (or LLC) must be respected and the senior generation (the primary transferor) should retain no, or as little as possible, income from the partnership. If income flow is necessary requiring the payment of an annuity from the partnership, not related to the amount of income, should be considered.
>
> Second, if possible, family members should pool assets rather than having the senior generation make substantially all the contributions. Family trusts should be considered as contributors in this regard. Nonetheless, the partnership income tax rules relating to investment companies cannot be disregarded.
>
> Third, if possible, assets other than or in addition to marketable securities should be used. If a client has both marketable securities and other assets (e.g. actively managed real estate interests), the investment company rules suggest keeping the assets in separate entities for income tax purposes. May simultaneous creation of two or more entities allow those entities to be treated, by the taxpayer, as if they were akin to one entity for transfer tax purposes while maintaining separate tax status for income tax purposes?
>
> Fourth, because the Tax Court majority seems to have rejected a "gift on formation" argument, the primary transferor should not have control of the entity even at the beginning. An exception may be if the primary transferor is a QTIP trust; will section 2519 apply if the surviving spouse consents to the transfer of liquid assets into an illiquid investment, especially if there is no guaranteed income flow from the entity? If that is a concern, may it be mitigated by leaving sufficient assets in the QTIP after the entity is funded to allow the trustee to make distributions (using principal) equivalent to the amount of income the trust would have if the entity distributed all of its income?
>
> Fifth, if section 2036 (a) (2) is a concern (based on the broad conclusions of Judge Cohen in Strangi) then the primary transferor should retain no partnership interests at all. Instead, the limited interests should be owned by a trust over which a testamentary special power of appointment is retained. Ideally the primary transferor would retain no significant rights over such a trust, including no right to receive income.

A different issue was present in Estate of Threefoot, 316 F. Supp. 2d 636 (W.D. Tenn. 2004). The decedent died before forming a limited partnership with her daughter ("Miller") in which she would own 99% and daughter 1%. The court noted the following facts:

> Under the Partnership Agreement and a related Subscription Agreement, Threefoot would have agreed to contribute to the Partnership all of her interest in certain tracts of real estate in Perry County, Tennessee (the "Perry County real estate") and in certain securities, bonds, and cash in her brokerage accounts. The Certificate of Formation for the Partnership was signed by Miller and filed with the Tennessee Secretary of State on September 16, 2002, and with the Shelby County Register on September 23, 2002. The Partnership Agreement and Subscription Materials for the Partnership were prepared by September 20, 2002, but they were not executed prior to Threefoot's death on September 23, 2002. Threefoot died testate.

> Miller alleges that she and Threefoot made a binding oral agreement to enter into the Partnership Agreement and seeks to enforce that oral agreement. As executrix, she requests that the court authorize the execution and consummation of the transactions outlined in the Partnership Agreement and the Subscription Agreement. Additionally, she states that there are insufficient liquid assets in Threefoot's estate to fully fund the Partnership and satisfy all current expenses, including estate taxes She requests that the court authorize the sale of an apartment located at 585 South Greer in Memphis, Tennessee (the "Memphis real estate") so that the proceeds can be used to satisfy those obligations.

The case began in Probate Court but was removed by the government to federal district court:

> On August 27, 2003, Anne W. Miller, as executrix of the estate of her mother, Anne F. Threefoot, brought a petition in the Probate Court of Shelby County, Tennessee. In that petition, Miller seeks to execute a Partnership Agreement on behalf of the estate, to transfer certain property to the partnership, and to sell certain real estate and fund the partnership with the proceeds. She also seeks a determination that the lien for federal estate taxes arising under 26 U.S.C. § 6324(a)(1) applies to the partnership interest which is part of the decedent's estate rather than to the property to be transferred to the partnership. Miller joined the United States as a party under 28 U.S.C. § 2410. The United States removed the case to this court on October 2, 2003, asserting that the court has federal question jurisdiction. Miller filed a motion to remand to state court on October 31, 2003, in which she also requests attorney's fees, and the United States filed a brief in opposition to the motion to remand on November 18, 2003. For the following reasons, Miller's motion to remand is GRANTED, and her request for attorney's fees is DENIED.

The issue before the court, then, was subject matter jurisdiction. The opinion states:

> When a federal court lacks subject-matter jurisdiction over an action that has been removed, it should remand the case to state court, 28 U.S.C. § 1447(c). The party seeking removal bears the burden of establishing that federal jurisdiction exists. <u>Ahearn v. Charter Township of Bloomfield</u>, 100 F.3d 451, 453-54 (6th Cir. 1996). "Due regard for state governments' rightful independence requires federal courts scrupulously to confine their own jurisdiction to precise statutory limits." Id. at 454.
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> The government contends that this court has federal question jurisdiction under the quiet title provision of the Judiciary Code, which provides in part:
>
>> [T]he United States may be named a party in any civil action or suit in any district court, or in any State court having jurisdiction of the subject matter -- (1) to quiet title to . . . real or personal property on which the United States has or claims a mortgage or other lien.
>
> 28 U.S.C. § 2410(a). The government asserts that it has a federal estate tax lien against the gross estate of Threefoot, which arose under 26 U.S.C. § 63241 on the date of her death.
>
> A related statute, 28 U.S.C. § 1444, provides:

> Any action brought under section 2410 of this title against the United States in any State court may be removed by the United States to the district court of the United States for the district and division in which the action is pending.

Miller argues that her petition is not an action to quiet title within the meaning of § 2410, although her petition does state that the United States should be joined as a party under § 2410 "for the purpose of quieting title to the property that the decedent agreed to transfer to the Partnership." Rather, she seeks to determine the property that is subject to the federal estate tax lien. In other words, among other relief, she seeks to determine whether certain property is part of the gross estate. The United States characterizes the action as follows: "the Court need only determine if an alleged oral contract and a family limited partnership are valid."

In support of her argument, Miller cites Walters v. Schmidt, 1979 WL 1376 (E.D. Mo. March 14, 1979). In Walters, the plaintiff brought suit in Missouri state court to contest the probate of her husband's will. Id. at *1. She alleged that a determination about the validity of the will would affect the amount due to the United States under 26 U.S.C. § 6324. Id. The United States removed the case to federal court. The court dismissed the action for lack of subject matter jurisdiction, finding that "[i]n order for the United States to be a proper party to this will contest under 28 U.S.C. § 2410(a), the plaintiff's allegations must relate to the legality of the procedures used by the United States to enforce the tax lien and not to the validity of the tax assessment itself." Id. See also Aqua Bar & Lounge, Inc. v. United States Dep't of Treasury Internal Rev. Serv., 539 F.2d 935, 939-40 (3d Cir. 1976) (stating that § 2410 is a waiver of sovereign immunity to a suit brought by a taxpayer against the United States which challenges the validity of a federal tax lien and sale "so long as the taxpayer refrains from contesting the merits of the underlying tax assessment itself.)"

In Walters, the court noted that the § 6324 lien attaches to all assets of the gross estate, and that the lien would be valid regardless of the will contest. "The effect of the will contest is only to determine which assets are includable in the gross estate to which the lien attaches." 1979 WL 1376 at *1. Therefore, the court dismissed the action for lack of subject-matter jurisdiction. Id.

In a later case, Wieland v. Savetz, 734 F. Supp. 409 (E.D. Mo. 1990), the court reached a similar result. In Wieland, the plaintiffs filed suit in state court seeking a declaration as to the proper construction of a testamentary trust. Id. at 409. They joined as a defendant the Commissioner of the Internal Revenue Service, who removed the case to federal court. Id. The plaintiffs sought no affirmative relief from the Commissioner, but joined him as a defendant because Internal Revenue Service agents had raised the controversy regarding the interpretation of the trust by disallowing a marital deduction with respect to the trust estate. Id. The court remanded the action to state court, stating:

> Upon reviewing plaintiffs' complaint, the Court concludes that plaintiffs seek a declaration of the proper construction of a testamentary trust under state law. Although this determination may have resulting tax implications, plaintiffs do not seek a determination of federal tax liability nor is such a determination necessary to their state law cause of action. The mere fact that the Commissioner, a federal official, has been named as a defendant herein does not provide a basis for the exercise of federal question jurisdiction.

Id. at 410.

Miller argues that hers is not an action to quiet title. Quiet title actions have been defined as those seeking "a determination that a tax lien does not exist, has been extinguished, or is inferior in rank." Estate of Johnson v. United States, 836 F.2d 940, 946 (5th Cir. 1988) (citation and emphasis omitted). Miller's action seeks enforcement of an alleged oral agreement, authorization to sell certain property, and a determination as to what property is subject to the § 6324 lien. Although Miller stated in her petition that she sought to quiet title to certain property, that statement does not give rise to federal jurisdiction if § 2410 does not in fact apply to her action. See Walters, 1979 WL 1376, at *1 (finding that no subject matter jurisdiction existed although the plaintiff cited § 6324 and joined the United States as a party pursuant to § 2410). This case does not involve the types of actions described in Johnson. Rather, in this case, as in Walters and Wieland, the resolution of the state law issues will determine whether certain property is included in the gross estate, which in turn affects the amount of federal estate tax, if any, owed. Miller seeks no affirmative relief from the United States. The United States has not satisfied its burden of demonstrating that federal subject matter jurisdiction exists.

Even if the court had found subject matter jurisdiction it would have remanded the case because of the probate exception, which the court discussed as follows:

Alternatively, even assuming that Millers probate court petition did raise a federal question, it would be inappropriate for this court to consider the case because of the probate exception to federal jurisdiction, which extends to matters that would require a federal court to interfere with the probate of an estate. *See, e.g.,* Bedo v. McGuire, 767 F.2d 305, 306 (6th Cir. 1985) ("It is well settled that federal courts have no probate jurisdiction."); Mangieri v. Mangieri, 226 F.3d 1, 2-3 (1st Cir. 2000) ("As a general matter, courts tend to view the probate exception as extending to all suits 'ancillary' to the probate of a will.") (internal quotation omitted). In Markham v. Allen, the Supreme Court stated that "a federal court has no jurisdiction to probate a will or administer an estate, the reason being that the equity jurisdiction conferred by the Judiciary Act of 1789 . . . did not extend to probate matters." 326 U.S. 490, 494 (1946). "[F]ederal courts of equity have jurisdiction to entertain suits in favor of creditors, legatees and heirs and other claimants against a decedent's estate to establish their claims so long as the federal court does not interfere with the probate proceedings or assume general jurisdiction of the probate or control of the property in the custody of the state court." *Id.* (internal quotations omitted, citing Waterman v. Canal-Louisiana Bank & Trust Co., 215 U.S. 33, 43 (1909)).

There are several policy reasons underlying the probate exception to federal jurisdiction. See Dragan v. Miller, 679 F.2d 712, 714 (7th Cir. 1982). First, it promotes legal certainty by limiting probate matters to one court system. "Certainty is desirable in every area of the law but has been thought especially so with regard to the transfer of property at death." *Id.* Second, it promotes judicial economy. The disposition of a decedent's assets normally begins in state court, and the probate exception "serves to preserve the resources of both the federal and state judicial systems and avoids the piecemeal or haphazard resolution of all matters surrounding the disposition of the decedent's wishes." Storm v. Storm, 328 F.3d 941, 944 (7th Cir. 2003). Third, the state probate courts have more expertise in deciding probate questions. "Because state courts have nearly exclusive jurisdiction over probate matters, state judges vested with probate jurisdiction develop a greater familiarity with such legal issues. " *Id.* A final, related reason for the probate exception is to avoid unnecessary interference with state courts: "if state courts have the exclusive task of probating a will, and thus develop the relative expertise to do so (including the expertise to deal with all matters ancillary to probate), then federal court resolution of such matters is . . . an unnecessary interference with the state system." *Id.*

* * *

A two-part inquiry governs whether the probate exception applies to bar Miller's suit from federal court. The first question is whether the court is being asked to probate a will or administer an estate. The second question is whether entertaining the action would cause the court to interfere with the probate proceedings or assume general jurisdiction or control of property in custody of the state court. Moser v. Pollin, 294 F.3d 335, 340 (2d Cir. 2002). If the answer to either question is yes, the case should be remanded for lack of subject matter jurisdiction. The "interference prong" is "the workhorse of the probate exception." Id.

The Moser court stated that the first question, whether the court is being asked to probate a will or an [sic] administer an estate directly, is rarely answered affirmatively, "since few practitioners would be so misdirected as to seek, for example, letters testamentary or letters of administration from a federal judge. Id. The same is true here; the first test is not met because Miller's action is not a "purely probate" matter.

The second question is whether the court is being asked to interfere with the probate proceedings, to assume general jurisdiction of the probate, or to assume control of property in the custody of the state court. If any of those three situations exists, the probate exception applies and the action should be remanded.

Miller's petition seeks resolution of three questions: (1) whether the alleged oral agreement between Threefoot and Miller is enforceable, (2) whether Miller may sell the Memphis real estate in order to satisfy the estate's obligations, and (3) whether the property Threefoot allegedly agreed to transfer to the Partnership is part of her gross estate. The first question is a contract question that merely involves an estate, and it is the sort of question that federal courts can answer despite the probate exception where jurisdiction exists. See Markham, 326 U.S. at 494 (noting that federal courts can entertain suits in favor of claimants against an estate to establish their claims). The second question presented by Miller's petition, however, is much more closely related to the probate proceeding in that it asks the court to order the sale of an asset of the estate. In requesting that the court authorize the sale of the Memphis real estate, Miller does not seek to determine the rights of a specific creditor, legatee, or heir. Rather, she asks that the court authorize the transfer of that property in order that its proceeds be used to pay "all costs of administration, including attorneys, fees and all just and lawful claims against the decedent's estate." Deciding whether to authorize the sale of real estate in Threefoot's estate would require the court to interfere with the probate proceedings, in the sense that this court would be directing disposition of the estate's assets. See Torelli v. Torelli, 941 F. Supp. 36, 39 (S.D.N.Y. 1996) (holding that probate exception applied to bar suit seeking to clear title to real estate and arrange for its sale); cf. Ashton v. Josephine Bay Paul and C. Michael Paul Found., Inc., 918 F.2d 1065, 1072 (2d Cir. 1990) ("[T]he Supreme Court has regularly rebuked the few efforts of lower federal

> courts to take over, generally, the administration of a decedent's estate, including the exercise of otherwise proper jurisdiction over the accounting of an estate.") (internal quotations and citations omitted). Therefore, as an alternate ground for remanding the suit the probate exception applies to bar this court from exercising jurisdiction.
>
> The government argues that the issues presented by Miller will not interfere with the probate of Threefoot's estate. (Govt.'s Opp'n at 6-7.) It states that "[n]o party is contesting the will itself or any bequest made pursuant to the will. Moreover, Miller alleges that the real property at issue is not even part of the decedent's estate. To the contrary: she alleges that the decedent transferred the property before her death into a family limited partnership." (Id.) However, Miller does seek to sell real property in Threefoot's estate (the Memphis real estate), which is separate from the real property she contends Threefoot agreed to transfer to the Partnership (the Perry County real estate).
>
> The government also argues that the probate exception does not apply to disputes over will substitutes, such as trusts. That argument is not supported by case law. See Macken ex rel. Macken v. Jensen, 333 F.3d 797, 799 (7th Cir. 2003) ("the probate exception applies to disputes about trusts used in lieu of wills, if the parties present an issue that would be resolved in probate had a will been used, or the issue is ancillary to such a dispute"); Storm, 328 F.3d at 947 ("Given the growth in recent years of various 'will substitutes,' we are loath to throw open the doors of the federal courts to disputes over testamentary intent simply because a decedent chose to use a will substitute rather than a traditional will to dispose of his or her estate."); Georges v. Glick, 856 F.2d 971, 974 n. 2 (7th Cir. 1988) (rejecting argument that probate exception was inapplicable because the action related to an inter vivos trust rather than a will). The single case cited by the government in support of its argument, Beattie v. J.M. Tull Foundation, 941 F. Supp. 57, 59 (D.S.C. 1996), is distinguishable. In Beattie, a trustee brought suit seeking a declaratory judgment that the terms of a testamentary trust permitted him to distribute the entire capital gain of the trust to the life tenant. Id. at 958. The court acknowledged that the distribution of the trust's assets was tangentially related to administration of the estate, but the court held that the action was not barred by the probate exception because it did not require the court "to disturb possession of an estate properly in the hands of a state probate court. Presumably, after thirty years, the estate has already been administrated and closed." Id. at 959. In this case, by contrast, the probate estate remains open and its assets are subject to the jurisdiction of the Shelby County Probate Court. (Mem. in Supp. of Mot. to Remand at 5.) Considering the facts of this case and the case law applying the probate exception, the court finds that the exception applies here and warrants remand of the action to the Shelby County Probate Court.

2. **How Long Is Three Years**? Section 2035(b) includes in a decedent's gross estate the amount of gift tax paid on gifts made during the three years immediately preceding the decedent's death. What if the time is exactly three years? In TAM 200432016 the IRS answered that for purposes of section 2035 the time begins running on the day of the gift. For instance, if decedent made gifts on January 1 of 2000 and died on January 1, 2003 the gifts were made three years and one day before death.

3. **Retained Interest in a Residence**. In Estate of Timothy J. Tehan v. Commissioner, T. C. Memo 2005-128, the decedent and his children had an agreement which allowed the decedent to continue living in his

residence until his death and required him to pay all expenses. The court found that the children never paid any expenses, used the residence, or attempted to exercise control over the residence. Thus section 2036(a)(1) applied to include the residence in the decedent's estate.

J. SECTIONS 2041 AND 2514 — GENERAL POWERS OF APPOINTMENT

1. **Inadvertent Exercise of Power of Appointment**. The danger of inadvertently exercising a power of appointment is evident in Estate of Sarah W. Grove v. Commissioner, T.C. Memo 2004-91. In 1933, Sarah S. Wright, decedent's grandmother created a general power in decedent. Decedent never knew about the power, which would have excluded the assets from her estate because the power was created before October 21, 1942, but under Pennsylvania law her residuary clause exercised it!

K. SECTIONS 61, 83, 2042 AND 7872 - LIFE INSURANCE

1. **Policy Transferred to LLC Within Three Years of Death Included in Gross Estate**. In PLR 200432015 the decedent transferred an insurance policy and cash to an LLC, and the decedent's wife contributed cash, in year one. In year two decedent and spouse contributed bonds and cash to the LLC. The assets were credited to the decedent's and spouse's capital accounts equally. Decedent continued to make the premium payments on the insurance policy after the transfer to the LLC although the LLC had sufficient assets to make them. Sometime in year one, decedent and spouse gave their interests in the LLC to their children. Decedent died within 60 days of the gift of the LLC interests to the children and within 16 months of the initial transfer of the insurance to the LLC.

At issue was whether the transfer to the LLC was a bona fide sale for adequate and full consideration. If not, then the policy would be included in decedent's estate through section 2035 and 2042; if it were, then there would be no inclusion. Relying upon Estate of Harper the IRS determined that the purpose of the transfer was not to contribute to the activities of an "ongoing business enterprise" but rather to remove assets from the decedent's estate. Thus, the increase in the decedent's capital account on account of the transfer to the LLC was not a bona fide sale for full and adequate consideration. Thus, the policy would be included in the decedent's gross estate. Because the proceeds were paid to the LLC there was no marital deduction for them even though the spouse owned a percentage of the LLC.

This private letter ruling agrees with the Services' litigating position in the family limited partnership cases.

2. **Transfer Between Grantor Trusts Not a Transfer for Value**. Section 101 provides that if an insurance policy is transferred for a valuable consideration prior to the death of the insured the usual rule that the insurance proceeds are income tax free does not apply. A transfer of value that is nonetheless to the insured is not a transfer for value. The IRS ruling position is that a transfer of a policy to a trust of which the insured is the grantor, and the trust is a wholly grantor trust, is a transfer to the insured and hence there is no transfer for value. See PLRs 200518061, 200514001, 200514002, 200247006, 200228019, 200120007. A transfer from one life insurance to

another, where the trusts are grantor trusts, is a useful way to avoid the three-year inclusion rule of sections 2042 and 2035. Care must be taken to ensure that the recipient trust, in particular, is a grantor trust for all purposes.

3. **Life Insurance Owned In Fiduciary Capacity**. In Rev. Rul. 84-179 the decedent purchased an insurance policy on his life and transferred all incidents of ownership to his wife. She subsequently died and the policy passed into a residuary trust for the benefit of the decedent's child. Decedent was trustee of the trust and controlled investments and distributions of the trust assets including the policy but the decedent as trustee could not exercise the powers of trustee for his own benefit. He used trust assets to pay the premiums and died as trustee with the trust owning the policy. The proceeds were not included in the decedent's estate. However, if the powers over the policy could have been used for the decedent's benefit there would have been inclusion, citing Estate of Fruehauf v. Commissioner, 427 F.2d 80 (6^{th} Cir. 1970). In PLR 200518005 this issue arose where the taxpayer was a co-trustee and income beneficiary of two trusts. Prior to the purchase of life insurance by the trusts, the co-trustee renounced her powers as co-trustee solely in connection with the insurance on her life and after the purchase resigned as trustee entirely. The IRS determined that she never had any incidents of ownership in the policies so long as no income from the trusts were used to pay the insurance premiums.

4. **Insurable Interest Rules**. In Chawla ex rel. Giesinger v. Transamerica Occidental Life Insurance Company, Slip Copy, 2005 WL 405405 (E.D. Va. 2005), the court held that a trust which was the owner and beneficiary of a life insurance policy did not, under applicable state law (Maryland) have an insurable interest in the decedent thus the policy was void. Under Maryland law, in order to have an insurable interest the trust must have had "a lawful and substantial economic interest in the continuation of the life, health, bodily safety of the individual" which the court determined the trust did not have because the trust was worth more after the death of the insured than it was before the death and suffered no financial loss on account of the death. On the particular facts, the insurance company contested the policy claiming that the insured did not make various required medical disclosures, such as recent brain surgery and that the decedent abused alcohol; the insured died less than two years after applying for the policy.

The issue of "insurable interests" has arisen recently in other contexts, particularly "corporate owned life insurance and insurance owned by charities. Congress is considering action in these areas.

L. SECTION 2053 and 2054 - DEBTS AND ADMINISTRATION EXPENSES

1. **Income Taxes on IRA**. Section 2053(c)(1)(B) provides that income taxes paid on income received after a decedent's death are not deductible under section 2053. In TAM 200444021 the IRS considered whether that provision could be avoided where an estate was required to withdraw funds from an IRA to pay estate taxes. The estate analogized the income tax to expenses of selling an asset in a "forced sale." The IRS rejected the claim reading section 2053 to allow taxes to be deducted only as direct claims against an estate not in any other way.

2. **<u>Deductibility of Interest On Funds Borrowed to Pay Estate Tax</u>**. Revenue Ruling 84-75 states that interest on a loan obtained by the executor of an estate to pay estate tax is deductible if it was reasonably and necessarily incurred. There the loan was necessary to avoid a forced sale of assets. However, the interest was deductible only as it was paid because the loan could be prepaid and the interest avoided. In <u>Estate of Graegin v. Commissioner</u>, T. C. Memo 1988-477, the court allowed an estate to deduct on the Form 706 interest which would be payable over the lifetime of a loan because the loan was structured in such a way as to require the interest to be paid even if the loan were prepaid. The estate was illiquid because it owned an interest in a business. In PLR 200449031 the IRS allowed a section 2053 deduction where a closely-held business was involved and the funds were borrowed from a bank.

If a substantial part of an estate consists of limited partnership interests over which the executor has no control the estate may be thought of as illiquid. If the estate borrows funds to pay the estate tax does that make the interest on the borrowing deductible on the Form 706 if it is structured as a Graegin type loan? Stated another way, is the borrowing reasonable and necessary to administer the estate? Predictably the IRS will argue that it is not.

In TAM 200513028 the Service confronted this situation. The residue of the estate was primarily decedent's 99% interest in a partnership, of which 57.6% of the assets were cash and marketable securities and the remainder either real estate or notes held by the partnership as a result of real estate sales. Child was general partner of the partnership and was co-executor with an accountant. The partnership loaned money to the estate on a 10 year Graegin type loan with the limited partnership interests as security. The TAM notes that on the date the note was signed the prime interest rate was 1% less than the interest rate on the note and the average interest rate for 15 year mortgage loans was 3% less.

The IRS disallowed the interest as an administration expense because it did not think the borrowing was really necessary but also because it doubted that the loan would really be repaid and even if it were it would have no economic effect on the parties. With respect to the first issue, the TAM states:

> First, we do not believe the transaction whereby the Estate purportedly borrowed \$m from Partnership can properly be viewed as necessary to the administration of the estate. As the case law and revenue rulings noted above indicate, the interest deduction has been allowed where the loan was necessary to preserve the asset value of the estate; for example, where the estate is illiquid, cash is needed to pay the federal and/or state estate tax liability, and the loan supplies this cash while avoiding the need to sell a family business or otherwise dispose of estate property at distressed or reduced prices.
>
> In this case, Partnership held substantial liquid assets totaling \$n, or 57.6% of the partnership assets. On his death, the Estate succeeded to Decedent's 99% partnership interest. Child A, the co-executor of the Estate, was the remaining general partner. Further, the partnership was not engaged in any active business that would necessitate the retention of liquid assets. In addition, in view of the Estate's 99% ownership interest in the partnership and Child A's 1% interest, there was clearly no fiduciary restraint on Child A's ability to access the funds.

> It may be argued that the Estate could not require the Partnership to distribute the funds, since the Estate possessed only a 99% "assignee" interest (as characterized by the Estate) and Child A, in her individual capacity, was the remaining general partner. However, the situation presented here is very different from the situations presented in Estate of Todd v. Commissioner, Estate of Graegin v. Commissioner and the other cases and revenue rulings cited above. In this case:
>
>> (i) the Estate owned 99% of the partnership,
>>
>> (ii) Child A was the co-executor of the Estate and held the remaining 1% partnership interest as a general partner,
>>
>> (iii) residuary trusts for Child A and Child B were to receive the Estate's 99% Partnership interest, and 99% of Partnership income was payable or would be credited to the trusts;
>>
>> (iv) Child A and Child B are each to receive (for support, maintenance, health, and other amounts as appropriate) the income and principal paid to the partnership and then distributed by the partnership to the trusts; and
>>
>> (v) Child A and Child B each hold a testamentary general power to appoint a respective half of 99% of Partnership along with any income and principal either retained by Partnership or paid by Partnership to the trusts but not distributed.
>
> It seems clear that the same parties (closely related family members whose proportionate interests in the Estate are virtually identical to their proportionate interests in the partnership) stood on all sides of this transaction. Thus, the assets held in Partnership were readily available for the purposes of paying the federal estate tax. Rather, we believe that in view of the availability of the liquid assets to the Estate and its beneficiaries, and in view of the structure of the loan (10-year term with prepayment prohibited), the only reason the loan transaction was entered into was to obtain an "upfront" estate tax deduction for the interest expense (an expense, which, as discussed below, is largely illusory.) However, as indicated above, in order for the interest expense to be deductible under § 2053, the loan must be necessary for the administration of the estate. The interest deduction can not be the justification for an otherwise unnecessary loan. Thus, we do not believe the loan can properly be characterized as necessary to the administration of the estate.

With respect to the second and third, the IRS' argument is that the circular flow of funds cannot generate a deduction, relying for that conclusion on a number of income tax cases. The IRS cites one transfer tax case, Geftman v. Commissioner, 154 F.3d 61 (3rd Cir. 1998), for the proposition that where the same individuals control both the transferor and transferee the true economic intent of the transaction must be determined objectively regardless of appearance. That case could as easily be read as noting that where the relevant documentation is not that of a loan there is no loan.

In an unpublished opinion, the California Court of Appeals approved a loan to pay estate taxes. Klein v. Hughes, 2004 WL 838198 (Cal.App. 1 Dist.). Mark Hughes, the founder of Herbalife, Inc., died with a $300 million estate. The IRS and the estate settled with respect to the estate taxes and then negotiated how they were to be paid. The transaction as finally structured, and approved by the court, was for the estate's tax counsel and his family to form a partnership, for an LLC owned by the decedent's revocable trust to make a loan to the new partnership, with interest and principal due in 2027, and for the partnership in turn to make a loan to the trust for the taxes. The partnership intermediary received a loan fee up front and pocketed a 0.15% spread between the interest rate it was charged and it charged, a profit of about $12 million over the term of the loan. The LLC from which the funds came would owe income tax on the interest. The net savings to the estate was almost $167 million. Apparently the IRS agreed to this arrangement so long as the intermediary was not controlled by the estate or revocable trust or any entity controlled by either. Presumably having the third party to profit ensured that the transaction would not simply be collapsed after the audit and the presence of an operating business rather than a securities partnership made the IRS more amenable to acceptance of the arrangement.

In Dorothy L. Rupert v. United States, 358 F. Supp. 2d 421 (M.D. Pa. 2004), the issue was payment of estate tax on unpaid lottery winnings. Mrs. Rupert won in 1991 at age 79 and died in 1997 with $630,000 per year to be paid for the balance of the term. Her estate was worth almost $7,000,000 of which almost $5,600,000 were unpaid lottery proceeds. To pay the estate tax funds were borrowed for 14 years at a fixed rate with the proceeds as the only collateral. The IRS argued that the annuity stream could have been sold and thus the loan unnecessary. The court disagreed and held that the estate should be given the opportunity to show the reasonableness and necessity of a loan. The court noted that it believed the estate considered the sale of annuity payments the equivalent of a forced sale of stock but there was no evidence in the record of that. The estate has the burden of proof at trial.

M. SECTIONS 2056, 2056A AND 2519- MARITAL DEDUCTION

1. **Omitted Assets Qualify for QTIP.**. In PLR 200430002 the estate omitted securities from Schedule B. On Schedule M the estate had QTIPed all assets of the estate other than various Schedule E joint assets. Because Schedule M included 100% of the estate assets other than joint property the additional assets were deemed part of the QTIP election too.

2. **Restriction on Income**. The following clause was found not to give the surviving spouse "all the income" for purposes of section 2056 by the Tax Court in Estate of Ralph H. Davis, et al. v. Commissioner, T.C. Memo 2003-55, affirmed by the Ninth Circuit at 394 F. 3d 1294 (2005):

> After the death of trustor survived by his spouse and during the lifetime of his surviving spouse, the trustee shall pay to or apply for the benefit of the surviving spouse, in quarter annual or more frequent installments, all of the net income from the trust estate as the trustee, in the trustee's reasonable discretion, shall determine to be proper for the health, education, or support, maintenance, comfort and welfare of grantor's surviving spouse in accordance with the surviving spouse's accustomed manner of living.

Both courts held that Mrs. Davis, the surviving spouse, did not have an unrestricted right to receive the income from the trust. That Mrs. Davis was the sole trustee of the trust was irrelevant because she might not always hold that position. The courts also rejected the application of a California statute which would have reformed the trust to meet the qualifications of a QTIP trust because they found no evidence from the document that Mr. Davis intended the trust to qualify for the marital deduction.

At issue in Estate of Zorn v. Zorn Farms, Inc., 62 P.3d 854 (Or. Ct. App. 2003), was the extent of a spouse's right to make unproductive property "productive" in a marital trust. The Court held that where it was clear a settlor intended for land to be retained, unproductive land could be sold only to meet "present or immediately foreseeable" income needs. Whether such a limited reading violates section 2056(b)(5) is unclear. In TAM 200339003, the IRS allowed a marital deduction for non-dividend paying stock passing to a QTIP because of the spouse's power to make the property productive.

In TAM 200444023 the IRS agreed that where a spouse could withdraw all the assets of a trust she was entitled to all the income and thus the trust would qualify for QTIP even though she could also direct trustee to distribute income to others under the trust agreement. Wife's power of withdrawal did not terminate in the event of her incapacity.

In TAM 200505022 trustee was to "distribute the net income of the Trust created hereby to my wife in such amounts and at such times as my wife, in her sole discretion but in consultation with the Trustee, shall desire for her maintenance, education, health or support commensurate with her station in life." The trust also authorized principal distributions for similar standards (omitting the reference to her station in life) and provided that undistributed income would be added to principal. The instrument contained no reference to the marital deduction but the estate did submit two letters from the drafting attorney written to the decedent stating that the spouse would receive all the income if she asked trustee for it. The IRS declined to find any ambiguity in the language and denied the marital deduction.

3. Surviving Spouse's Disclaimer Creates Overfunding and Tax. Estate of David Katz, T. C. Memo 2004-166, dealt with odd facts. Article 3 of Mr. Katz's will provided for an amount equal to the exemption equivalent to be held in trust. The amount so set aside was not to be reduced on account of any disclaimer by Mrs. Katz. Article 4 disposed of the residue of the estate, bequeathing it in fee to Mrs. Katz. If Mrs. Katz disclaimed any interest in the residue it was to pass to the Article 3 trust. Mrs. Katz disclaimed various securities and any interest she had in the Article 3 trust, apparently thinking that she was disclaiming specific property only. The IRS argued, and the Tax Court agreed, that the disclaimed securities were added to the Article 3 trust by her disclaimer such that it was overfunded creating a taxable estate.

4. **Obtaining Step-Up In Basis**. PLR 200403094 is important. Husband created a trust and funded it with his own assets. The trust allowed him to revoke or amend it during his lifetime and to withdraw income and principal. The trust also gave his wife a testamentary general power of appointment if she died first:

> At my wife's death, if I am still living, I give to my wife a testamentary general power of appointment, exercisable alone and in all events to appoint part of the assets of the Trust Estate, having a value equal to (i) the amount of my wife's remaining applicable exclusion amount less (ii) the value of my wife's taxable estate determined by excluding the amount of those assets subject to this power, free of trust to my deceased wife's estate or to or for the benefit of one or more persons or entities, in such proportions, outright, in trust, or otherwise as my wife may direct in her Will.

If husband died first a traditional marital/exemption equivalent plan would be implemented with the marital share passing outright to wife, and the exemption equivalent share being held in a Family Trust for wife and for husband's descendants, subject to ascertainable standards. Wife also had a testamentary special power of appointment among husband's descendants.

The ruling states that wife intends to execute a Will which was described as follows:

> Wife plans to execute Will. Article 2.1 of Will makes gifts of Wife's tangible personality.
>
> Article 2.2 of Will provides:
>
> > I exercise in favor of my estate the power of appointment given to me by Section 4.5 of the Trust created by [Husband] dated [__], and direct that assets having a value equal to (i) the amount of my remaining applicable exclusion amount less (ii) the value of my taxable estate, determined by excluding the amount of those assets subject to this power, be distributed to my estate as soon after my death as possible.
>
> Article 2.3 of Will provides that if Husband survives Wife, Husband will receive a fraction of Wife's residuary estate, after the payment of estate taxes, debts, and expenses, determined as follows:
>
> > The numerator of the fraction will be the smallest pecuniary amount that, if given outright to [Husband], would eliminate or reduce to the lowest possible sum the state and federal estate tax liability of [Wife's] estate. This amount will be calculated by taking into account [Wife's] applicable exclusion amount and all other tax credits, deductions, and other preferences allowed to [Wife's] estate.
>
> The balance of the residuary estate will be held as a separate trust (Wife's Family Trust). If Husband does not survive Wife, the entire residuary estate will be held as the Family Trust. Under Article 3 of Will, any part of the gift to Husband that he disclaims will become part of Wife's Family Trust.

The Family Trust is parallel to the Family Trust described above.

The Service granted four rulings:

> 1. On the death of Wife during Husband's lifetime, if Wife exercises the power of appointment granted her under article 4.5 of Trust, Husband will be treated as making a gift that qualifies for the federal gift tax marital deduction to Wife with respect to that portion of Trust appointed by Wife.
>
> 2. If Wife predeceases Husband, of the assets in Trust, the value of Trust assets over which Wife holds a power of appointment under article 4.5 of Trust will be included in Wife's gross estate.
>
> 3. Any assets that originated in Trust and that pass to or from Wife's Family Trust established under Will will not constitute a gift from Husband to the other beneficiaries of Wife's Family Trust.
>
> 4. Any assets that originated in Trust and that pass to Wife's Family Trust established under Will will not be included in Husband's gross estate.

Presumably the point of this exercise was for the assets in the trust passing into the Family Trust at the first death to receive a step-up in bases by reason of being included in the estate of the first to die. No income tax ruling is mentioned which suggests the Service was not prepared to rule (or to rule favorably) on the basis issue.

Assets which pass back to a donee surviving spouse from a donor deceased spouse where the gift occurred within one year are denied a basis step-up. Thus, the question is, would these assets pass from husband to wife to husband if wife died first and, of course, that depends on the status of husband and the Family Trust.

Also see PLR 200413011 where husband retained a special power of appointment over assets in an irrevocable trust, which passed into a QTIP if the power were released.

5. Effect of Disability Clause. In Estate of Merle A. Whiting, Jr. v. Commissioner, T.C. Memo 2004-68, the court applied Arkansas law to determine that a clause allowing trustee to accumulate income instead of distributing it to a disabled beneficiary would not apply to the marital deduction QTIP trust.

The opinion states:

> Decedent manifested his intent to qualify for the marital deduction in numerous ways. First, the trust agreement named two of the trusts in reference to the marital deduction: The "Marital Deduction Trust" and the "Non-Marital Deduction Trust". The name of a trust is evidence of decedent's intent.
>
> Second, it is evident from the trust agreement that decedent intended to minimize Federal estate taxes through the use of the marital deduction. See *Estate of Todd v. Commissioner,* 57 T.C. 288, 294 (1971) (references to the marital deduction and citations to section 2056 clearly establish that the trust's purpose was to secure the marital deduction). In valuing the assets to be placed in the marital deduction trust, the trust agreement states that decedent intended to "have the result of qualifying the marital deduction for estate tax purposes". Only assets which qualify for the marital deduction may be placed in the marital deduction

> trust. The amount of the distribution to the marital deduction trust is "the excess * * * of the decedent's taxable estate * * * over the exemption equivalent of the * * * unified credit". Additionally, the terms "marital deduction", "gross estate", and others are defined in the trust agreement as having the same meaning as the definitions found in the Internal Revenue Code.
>
> Third, the circumstances surrounding the drafting of the trust indicate that decedent intended to qualify for the marital deduction. Decedent knew that he was terminally ill and hired specialized tax attorneys to draft the trust: Two are Arkansas board recognized specialists in tax law, one is a certified public accountant, and two have a master of laws in taxation. The intent of the draftsman of the marital deduction trust was to create a trust which qualified for the marital deduction.

6. **Revocation of QTIP Election**. In PLR 200422050 the executor needed only to make a partial QTIP election to zero-out decedent's estate tax but instead made a QTIP election for the entire marital trust. The IRS refused to allow the executor to revoke part of the election. Rev. Proc. 2001-38 allows for a QTIP election to be disregarded when unnecessary to reduce the estate tax liability to zero. However, the Rev. Proc. specifically notes that it will not apply where a partial QTIP election was required to eliminate the estate tax but the executor QTIPed too much. The policy reasoning behind the distinction remains puzzling. What if the trustee had divided the trust such that no QTIP election at all would have been required for one of the new trusts? Would that have changed the result given that it would have occurred after death?

7. **No Relief For Excessive QTIP Election**. In PLR 200422050 a QTIP election was made for more of a marital trust than was necessary to produce zero estate tax and the IRS held that all of the trust for which the election was made would be included in the surviving spouse's estate under section 2044. The ruling denies all relief to the taxpayer:

> In the instant case, the taxpayer is not seeking an extension of time to make the QTIP election. Rather, the taxpayer is in effect seeking to partially revoke a QTIP election previously made, that, pursuant to § 2056(b)(7)(B)(v) is irrevocable. See Estate of Cavenaugh v. Commissioner, 100 T.C. 407 at 421 (1993). Accordingly, § 301.9100 is not applicable in this case.
>
> Furthermore, the situation presented is not within the purview of Rev. Proc. 2001-38, 2001-1 C.B. 1335. Pursuant to this revenue procedure, under certain circumstances, the Service will treat a QTIP election as null and void for purposes of §§ 2044(a), 2056(b)(7), 2519(a) and 2652. Rev. Proc. 2001-38 applies where the election was not necessary to reduce the estate tax liability to zero, based on values as finally determined for federal estate tax purposes. The revenue procedure does not apply in situations where a partial QTIP election was required with respect to a trust to reduce the estate tax liability and the executor made the election with respect to more trust property than was necessary to reduce the estate tax liability to zero.
>
> In this case, a QTIP election was required with respect to the marital trust to reduce Decedent's estate tax liability to zero. However, the election was made for more marital trust property than was necessary in order to reduce Decedent's

> estate tax liability to zero. This situation is specifically excluded from the purview of Rev. Proc. 2001-38. Accordingly, the QTIP election with respect to the entire marital trust is valid and effective for estate tax purposes. Therefore, 100 percent of the value of the marital trust on the applicable valuation date will be includible in Spouse's gross estate under § 2044.

N. SECTIONS 2501 TO 2524 - GIFTS

1. **Tax Payments in Grantor Trust Context**. Rev. Rul. 2004-64, 2004-27, considers the gift tax consequences when a grantor pays the income tax on income attributable to assets in a grantor trust, and the estate tax consequences if the grantor may be reimbursed by the trust for such income tax payments under the instrument or applicable state law.

The fact situations contemplated are:

> During Year 1, Trust receives taxable income of $10*x*. Pursuant to § 671, *A* includes the $10*x* in *A*'s taxable income. As a result, *A*'s personal income tax liability for Year 1 increases by $2.5*x*. *A* dies in Year 3. As of the date of *A*'s death, the fair market value of Trust's assets is $150*x*.
>
> *Situation 1*: Neither State law nor the governing instrument of Trust contains any provision requiring or permitting the trustee to distribute to *A* amounts sufficient to satisfy *A*'s income tax liability attributable to the inclusion of Trust's income in *A*'s taxable income. Accordingly, *A* pays the additional $2.5*x* liability from *A*'s own funds.
>
> *Situation 2*: The governing instrument of Trust provides that if *A* is treated as the owner of any portion of Trust pursuant to the provisions of subpart E for any taxable year, the trustee shall distribute to *A* for the taxable year, income or principal sufficient to satisfy *A*'s personal income tax liability attributable to the inclusion of all or part of Trust's income in *A*'s taxable income. Accordingly, the trustee distributes $2.5*x* to *A* to reimburse *A* for the $2.5*x* income tax liability.
>
> *Situation 3*: The governing instrument of Trust provides that if *A* is treated as the owner of any portion of Trust pursuant to the provisions of subpart E for any taxable year, the trustee may, in the trustee's discretion, distribute to *A* for the taxable year, income or principal sufficient to satisfy *A*'s personal income tax liability attributable to the inclusion of all or part of Trust's income in *A*'s taxable income. Pursuant to the exercise of the trustee's discretionary power, the trustee distributes $2.5*x* to *A* to reimburse *A* for the $2.5*x* income tax liability.

The Ruling is favorable as to Situation 1: no gift tax when the income tax is paid and no estate inclusion because no rights were retained.

With respect to Situation 2, the IRS was less favorable:

> In *Situation 2*, the governing instrument of Trust requires the trustee to reimburse *A* from Trust's assets for the amount of income tax *A* pays that is attributable to Trust's income. *A*'s payment of the $2.5*x* income tax liability does not constitute a gift by *A*, because *A* is liable for the tax. The trustee's

> distribution of $2.5*x* to *A* as reimbursement for the income tax payment by *A* is not a gift by the trust beneficiaries to *A*, because the distribution from Trust is mandated by the terms of the trust instrument.
>
> However, *A* has retained the right to have trust property expended in discharge of *A*'s legal obligation. *A*'s retained right to receive reimbursement attributable to Trust's income causes the full value of Trust's assets at *A*'s death ($150*x*) to be included in *A*'s gross estate under § 2036(a)(1). The result would be the same if, under applicable state law, the trustee must, unless the governing instrument provides otherwise, reimburse *A* for *A*'s personal income tax liability attributable to the inclusion of all or part of the Trust's income in *A*'s taxable income, and the governing instrument does not provide otherwise.

With respect to Trustee's discretion, Situation 3, the IRS was generally favorable assuming no express or implied understanding between grantor and beneficiary:

> In *Situation 3*, the governing instrument of Trust provides the trustee with the discretion to reimburse *A* from Trust's assets for the amount of income tax *A* pays that is attributable to Trust's income. As is the case in *Situation 1* and *Situation 2*, *A*'s payment of the $2.5*x* income tax liability does not constitute a gift by *A* because *A* is liable for the income tax. Further, the $2.5*x* paid to *A* from Trust as reimbursement for *A*'s income tax payment was distributed pursuant to the exercise of the trustee's discretionary authority granted under the terms of the trust instrument. Accordingly, this payment is not a gift by the trust beneficiaries to *A*. In addition, assuming there is no understanding, express or implied, between *A* and the trustee regarding the trustee's exercise of discretion, the trustee's discretion to satisfy *A*'s obligation would not alone cause the inclusion of the trust in *A*'s gross estate for federal estate tax purposes. This is the case regardless of whether or not the trustee actually reimburses *A* from Trust assets for the amount of income tax *A* pays that is attributable to Trust's income. The result would be the same if the trustee's discretion to reimburse *A* for this income tax is granted under applicable state law rather than under the governing instrument. However, such discretion combined with other facts (including but not limited to: an understanding or pre-existing arrangement between *A* and the trustee regarding the trustee's exercise of this discretion; a power retained by *A* to remove the trustee and name *A* as successor trustee; or applicable local law subjecting the trust assets to the claims of *A*'s creditors) may cause inclusion of Trust's assets in *A*'s gross estate for federal estate tax purposes.

Trusts created before October 4, 2004 are grandfathered for Situation 2 but not Situation 3. Suppose a Situation 3 trust exists where the trustee has reimbursed the grantor or other facts suggest an understanding? May the trust be reformed prior to October 4, 2004 to be a Situation 2 trust and thereby protected? The application of the Ruling to Crummey trusts must be considered as well.

2. <u>Indirect Gift to Partners Through Partnership Contributions</u>. In <u>Mark W. Senda</u>, T.C. Memo. 2004-160, Judge Cohen found that parents' contributions to family partnerships were in fact gifts to the children who were other partners. The partnerships were funded with marketable securities contributed by parents and on the same day partnership units were given to the children. The court found the transfer "to the partnership" to be illusory, citing the <u>Shepherd</u> case.

Section 25.2511-1(h)(1), Gift Tax Regs., provides that a transfer of property by a taxpayer to a corporation represents a gift by the taxpayer to the other shareholders of the corporation to the extent of their proportionate interests in the corporation. In Shepherd v. Commissioner, 115 T.C. 376, 389 (2000), affd. 283 F.3d 1258 (11th Cir. 2002), we applied the principle that, like a transfer of property to a corporation, a transfer of property to a partnership for less than full and adequate consideration may represent a gift to the other partners.

In Shepherd, the taxpayer transferred real property and stock to a newly formed family partnership in which he was a 50- percent owner and his two sons were each 25-percent owners. Id. at 380-381. Rather than allocating contributions to the capital account of the contributing partner, the partnership agreement provided that any contributions would be allocated pro rata to the capital accounts of each partner according to ownership. Id. at 380. Because the contributions were reflected partially in the capital accounts of the noncontributing partners, the value of the noncontributing partners' interests was enhanced by the contributions of the taxpayer. Accordingly, we held that the transfers to the partnership were indirect gifts by the taxpayer to his sons of undivided 25-percent interests in the real property and stock. Id. at 389. The Court of Appeals for the Eleventh Circuit affirmed our decision for the reasons stated in our Opinion.

Petitioners' transfers of stock in the instant case are similar to the transfer of property in Shepherd . In both cases, the value of the children's partnership interests was enhanced by their parents' contributions to the partnerships. Petitioners attempt to distinguish Shepherd by referring to our statement in that case that "not every capital contribution to a partnership results in a gift to the other partners, particularly where the contributing partner's capital account is increased by the amount of his contribution". Id. at 389. Petitioners argue that, in the instant case, petitioners' capital accounts were increased by the amount of their contributions. Petitioners further argue that, under Estate of Jones v. Commissioner, 116 T.C. 121 (2001), it is irrelevant that the contributions of the stock to the partnerships and the transfers of the partnership interests to the children occurred on the same day.

In Estate of Jones, the taxpayer contributed property to the partnerships and received continuing limited partnership interests in return. All of the contributions of property were properly reflected in the capital accounts of the taxpayer. Id. at 128. In the instant case, however, it is unclear whether petitioners' contributions of stock were ever reflected in their capital accounts. On cross-examination, petitioner testified with respect to SFLP I as follows:

> Q And, at that same time, certainly the same day, you transferred the partnership interests, limited partnership interests from yourself and Michele to the children, correct?
>
> A Yes, sir.
>
> Q And when did you do that? On December 28?

* * * * * * *

> A Well, keep in mind that these things have been weeks in the making. So the fact that they triggered at a particular day or on a particular day may or may not be relevant.
>
> The fact that that happened during that day, I couldn't tell you if it happened at 1:00, 3:00 or 5:00. If that's what you're asking me.
>
> Q That was what I was asking you. The transfer of the limited partnership interests, how did that occur on December 28, 1998?
>
> A How did that occur? Tell me where you're going. I'm not sure.
>
> * * * * * * *
>
> Q So how did you transfer it from yourself to the children?
>
> A How did I transfer? I'm not certain what the right, what you're looking for here.

> It is apparent from petitioner's evasive testimony and from the total record that petitioners were more concerned with ensuring that the beneficial ownership of the stock was transferred to the children in tax-advantaged form than they were with the formalities of FLPs. Indeed, petitioner, as general partner, did not maintain any books or records for the partnerships other than brokerage account statements and partnership tax returns. Those tax returns were prepared months after the transfers of the partnership interests. Thus, they are unreliable in deciding whether petitioners transferred the partnership interests to the children before or after they contributed the stock to the partnerships. The same is true of the certificates of ownership reflecting the transfers of the partnership interests, which were not prepared until at least several weeks after the transfers. The informality is not surprising, inasmuch as petitioners alone, individually, or on behalf of their minor children were united in purpose and acted without restraint by any adverse interest. As a result, however, petitioners have presented no reliable evidence that they contributed the stock to the partnerships before they transferred the partnership interests to the children. At best, the transactions were integrated (as asserted by respondent) and, in effect, simultaneous.

Interestingly, the government stipulated that partnership unit transfers after the day of funding (13 months and one month, respectively) were transfers of partnership units. Further, with respect to those transfers, the stipulated valuation discounts were between 39% and 46%.

O. SECTION 2518 - DISCLAIMERS

1. **Vow of Poverty Does Not Equal Disclaimer**. In TAM 200438042 the decedent bequeathed an apartment, its furnishings, plus cash and securities to his brother who was a priest who had taken a vow of poverty. The priest took the assets and gave them to the order and claimed a section 2055 deduction on the decedent's estate tax return on the theory that the transfer constituted a disclaimer. The IRS refused to treat the vow of poverty as a disclaimer because it was not a qualified disclaimer under applicable state law and because the vow would not have treated the brother as predeceasing as is the case with a disclaimer. A valid disclaimer could have been executed by brother but was not.

2. **Acceptance of Benefits**. In PLR 200503024 the surviving spouse transferred a joint brokerage account to her sole name, directed various sales and purchases within the account, and withdrew certain amounts of cash from the account, during the first eight months following husband's death. Wife then executed a disclaimer. The IRS allowed the disclaimer, for the most part, stating that transfer of title is ministerial and is not acceptance of assets and that the cash withdrawn may be severed and attributed to the wife's portion of the account prior to husband's death. However, wife may not disclaim the assets which were purchased after death (or, presumably the cash proceeds from sales).

P. SECTIONS 2601-2654 - GENERATION-SKIPPING TRANSFER TAX

1. **Modification of GST Exempt Trusts**. Many rulings continue to be issued approving various kinds of modifications to GST exempt trusts. In PLR 200430009 the trust required that a specified bank be trustee for each separate trust created under the pre-September 25, 1985 agreement. The bank resigned and the trusts were modified by court order to allow separate trustees for each trust. The modification did not affect the trusts grandfathered status. In PLR 200507002 a settlement which was the product of true arms-length negotiation was allowed to divide and modify a grandfathered trust and change the advisor and trustee. In PLR 200507010 a grandfathered trust was allowed to convert to a unitrust; the applicable state statute allowed a trustee to convert absent a beneficiary's objection. In PLRs 200502031 and 200502032 approval was granted to a trust division and unitrust conversion.

2. **Transfer of Remainder Interest**. PLR 200442020 and PLR 200443023 allowed court reformation of GST exempt trusts in order to permit the sale of remainder interests in the trusts. In particular, court approval lifting spendthrift provisions were at issue. The sales were of remainder interests in grandfathered trusts and the sales prices were set using the actuarial factors of section 7520.

3. **Section 2038 Produces ETIP**. In PLR 200419011the taxpayer spouses created trusts and were advisors with the power to approve principal distributions by trustee. As originally drafted the trust lacked ascertainable standards. Subsequently:

> Donor and all other interested parties, including Child 1, Child 2, and Child 3 in their capacities as trustees and beneficiaries, and the grandchildren as beneficiaries, obtained a court order that retroactively reformed Article VII(A)(2) and Article VIII(A)(2) of each of the seven trusts to include certain language that the parties contended had been omitted from the trust documents. Pursuant to the court order, Article VII(A)(2) and Article VIII(A)(2) were each reformed to read as follows:
>
> > 2. The Trustee is authorized and empowered in the Trustee's sole and absolute discretion at any time and from time to time, during the lifetime of said beneficiary, to disburse from the principal of the trust estate created under this Article (even to the point of completely exhausting same), such amounts as the Trustee may deem advisable to provide adequately and properly for the support and maintenance of the

> said beneficiary thereof, including but not by way of limitation, expenses incurred by reason of illness, disability and education. In determining the amount of principal to be so disbursed, the Trustee shall take into consideration any other income or property which such beneficiary may have from any other source; and the Trustee's discretion shall be conclusive as to the advisability of any such disbursement and the same shall not be questioned by anyone. For all sums so disbursed, the Trustee shall have full acquittance. [Emphasis added].

The parties contended that the italicized language was contained in early drafts of the trusts, but had been inadvertently deleted from the final versions that were executed by Spouse and Donor. In conjunction with a civil law suit, the parties involved had been deposed on issues concerning the creation of the trusts, including the deletion of the language at issue, (hereinafter referred to as ascertainable standard language). These depositions formed part of the record in the reformation action.

The IRS did not give effect to the reformation:

> Section 30-4-3-25 of Ind. Code Ann. (Michie 2002) provides:
>
> > Rescission and reformation. -- Upon petition by an interested party, the court may rescind or reform a trust according to the same general rules applying to rescission or reformation of nontrust transfers of property.
>
> In Estate of Reasor v. Putnam County, Indiana, 635 N.E. 2d 153 (Ind. 1994), the Indiana Supreme Court noted that written instruments are presumed to reflect the intentions of the parties to those instruments. Accordingly, ". . . to succeed in a reformation action a party must show either mutual mistake or fraud by clear and convincing evidence . . . [and] a party seeking reformation must also show the original intent or agreement of the parties by clear and convincing evidence. "Estate of Reasor v. Putnam County, Indiana, 635 N.E. 2d at 160. See also, Heavenridge v. Mondy, 49 Ind. 434 (Ind. 1875) ("It is settled law, that to entitle a party to the reformation of a written instrument, it must be clearly and satisfactorily shown that there was a mistake of fact, and not of law. It must be shown that words were inserted that were intended to be left out, or that words were omitted which were intended to be inserted."); Seufert v. Mulzer, 2000 U.S. Dist. Lexis 13665 (S.D. Ind. 2000) (Indiana law is in accord with the principle enunciated in Bogert & Bogert, The Law of Trusts and Trustees, 991 (2d ed. rev. 1983) to the effect that reformation will not be granted where the mistake was as to the legal effect of the wording of the instrument.)
>
> In the instant case, we do not believe the record provides clear and convincing evidence that a mistake of fact was made, as required under Indiana law. On the contrary, in the depositions noted above, Attorney testified that he had no recollection of why the ascertainable standard language was removed. On the other hand, there is specific testimony from Accountant that Spouse intended to delete the ascertainable standard language and that Spouse and Donor intended to make the invasion power very broad, and that Attorney had to be aware of the changes. Further, as discussed above, the actions of the trustees in managing the assets of the trusts have been consistent with the absence of any limitation that would have been imposed by the ascertainable standard language. Thus, our review of the record does not indicate that there was "clear and convincing

> evidence" of a mutual mistake or clear and convincing evidence that the terms of the executed instrument were contrary to the original intent of the grantors, the standard for reformation under Indiana law. Estate of Reasor v. Putnam County, Indiana, cited above. Thus, we conclude the reformation should not be given retroactive effect for transfer tax purposes.

Thus, section 2038 applied to created an ETIP:

> Donor and Spouse were members of the Advisory Committee from the creation of the trusts on Date 1, until their resignations on Date 4. Article XIII requires that the trustee consult with the Advisory Committee on all important matters, including discretionary payments of principal. Under the Article, the trustee is prohibited from taking any action involving discretionary payments of income and of principal without the unanimous consent or approval of the Advisory Committee. Only if the Advisory Committee fails to act within the time prescribed, may the trustee act in its own discretion "as if no Advisory Committee had been appointed." In addition, the Advisory Committee, acting unanimously and at its own discretion, may remove and replace an acting trustee and/or select a successor trustee, at any time and upon the death, incapacity, or resignation of a current trustee.
>
> As discussed above, we have concluded that the trustee's power to distribute corpus was not limited by an ascertainable standard. Accordingly, if this power was held directly by Donor and Spouse, as trustees, the corpus of each trust would be subject to inclusion in their respective gross estates under § 2038, to the extent of their contributions to the trusts. Rev. Rul. 73-143, cited above. In this case, although neither Donor nor Spouse were trustees, as members of the Advisory Committee, their consent was required before the trustee could make any distribution. The fact that this consent or veto power could be exercised only after the trustees initiated action does not alter the nature of the power as a power exercisable by Donor or Spouse in conjunction with others, within the purview of § 2038. Rev. Rul. 70-513, 1970-2 C.B. 194, citing Estate of Grossman v. Commissioner, 27 T.C. 707 (1957).1
>
> Because Donor and Spouse initially retained a power over the trusts that would cause trust property to be included in their gross estates under § 2038, the transfers by Donor and Spouse to the trusts were subject to an "estate tax inclusion period" under § 2642(f)(3), for purposes of the generation-skipping transfer tax. The estate tax inclusion period did not terminate until Date 4, the date that Donor and Spouse resigned from the Advisory Committee with respect to each of the trusts.
>
> Accordingly, for purposes of the generation-skipping transfer tax, an estate tax inclusion period did exist with respect to the transfers made by Donor and Spouse to the trusts.

4. **Proposed Regulations on Making Qualified Severances**. EGTRRA added in 2001 section 2642 (a) (3) to the Code which provides that a trust (for instance, with an inclusion ration of between one and zero) divided into two or more separate trusts by means of a "qualified severance" will be recognized as separate trusts for GST purposes. A trust may be severed at any time prior to its termination - - thus, a severance cannot affect a

taxable termination or taxable distribution which has occurred. The IRS issued Proposed Regulations on the meaning of qualified severance on August 23, 2004. REG-145987-03.

A qualified severance must occur pursuant to the terms of the governing instrument or applicable state law and must be effective under applicable state law. The trust must be severed on a fractional basis which may by formula (e.g. the numerator of the fraction may be equal to the transferor's unused GST exemption and the denominator may be the fair market value of the trust on the date of severance) but may not be a pecuniary formula ($1,500,000 to one new trust, the balance to the other new trust). The severance need not be pro rata but if funded on a non pro rata basis each new trust must be funded by multiplying the relevant fraction by the total fair market value of the old trust on the date of funding.

Further, the new trusts must provide, looked at together, for the same "succession of interests" as in the original trust. If the trusts are discretionary such that distributions may be made from one new trust to a certain beneficiary or beneficiaries (e.g. children) and distributions from another trust may be made to another beneficiary or beneficiaries (e.g. grandchildren), the requirement will still be met if the terms of the new trusts are the same as the terms of the original trust (including if a permissible beneficiary of the old trust is a beneficiary of only one of the new trusts), the severance does not shift an interest to a lower beneficiary than those with an interest in the original trust, and the severance does not extend the vesting period beyond that of the original trust.

If the original trust has had GST exemption allocated to it, the initial division must be into one new trust with an inclusion ratio of one and another with an inclusion ratio of zero. Subsequent qualified severances may then occur.

For purposes of section 1001 - - gain on the exchange of property - - the qualified severance of a trust will not be a taxable transaction. However, the applicable state statute or governing instrument must allow a non pro rata funding, otherwise the funding must be pro rata to avoid an exchange.

Taxpayers use Form 706-GS(T) to report a qualified severance by attaching a Notice of Severance and writing at the top, in red, "Qualified Severance." The Notice must describe how the trusts were funded including the fraction and must identify the new trusts. The return must be filed by April 15 following the year in which the severance occurred.

The proposed regulations contain various examples:

> <u>Example 1</u>. <u>Formula severance.</u> T's will establishes a testamentary marital trust (Trust) that qualifies as qualified terminable interest property (QTIP) under section 2056(b)(7). Trust provides that all trust income is to be paid to T's spouse for life. On the spouse's death, the trust corpus is to be held in further trust for the benefit of T's then-living descendants. On T's date of death in January of 2004, T's unused GST tax exemption is $1,200,000, $200,000 of which T's executor will allocate to bequests to T's grandchildren. Prior to the due

date for filing the Form 706, "United States Estate (and Generation-Skipping Transfer) Tax Return," for T's estate, and thus, prior to the allocation of any GST tax exemption with respect to Trust, T's executor, pursuant to applicable state law, divides Trust into two separate trusts, Trust 1 and Trust 2. Trust 1 is to be funded with that fraction of the Trust assets, the numerator of which is $1,000,000, and the denominator of which is the value of the Trust assets as finally determined for federal estate tax purposes. Trust 2 is to be funded with the balance of the Trust assets. On the Form 706 filed for the estate, T's executor makes a QTIP election under section 2056(b)(7) with respect to Trust 1 and Trust 2 and a reverse QTIP election under section 2652(a)(3) with respect to Trust 1. Further, T's executor allocates T's available GST tax exemption to Trust 1. If the requirements of section 2642(a)(3) are otherwise satisfied, the severance constitutes a qualified severance. Accordingly, Trust 1 and Trust 2 are treated as separate trusts, and the GST tax elections and GST tax exemption allocation are recognized and effective for generation-skipping transfer tax purposes.

Example 2. Severance of single trust with one income beneficiary. T's will establishes a testamentary trust providing that income is to be paid to T's sister, S, for her life. On S's death, one-half of the corpus is to be paid to T's child, C, or to C's estate if C fails to survive S and one-half of the corpus is to be paid to T's grandchild, GC, or to GC's estate if GC fails to survive S. Prior to the due date for filing the Form 706, T's executor, pursuant to applicable state law, divides the testamentary trust into two separate trusts, Trust 1 and Trust 2, with each trust receiving 50 percent of the current value of the assets of the original trust. Trust 1 provides that trust income is to be paid to S for life with remainder to C or C's estate, and Trust 2 provides that trust income is to be paid to S for life with remainder to GC or GC's estate. Because Trust 1 and Trust 2 provide for the same succession of interests in the aggregate as provided in the original trust, the severance will constitute a qualified severance if the requirements of section 2642(a)(3) are otherwise satisfied. On the Form 706, T's executor may allocate T's available GST tax exemption to Trust 2.

Example 3. Severance of discretionary trust. T's will establishes a testamentary trust (Trust) providing that income is to be paid from time to time in such amounts as the trustee deems advisable to T's children, A and B, and to their respective descendants. In addition, the trustee may distribute corpus to any trust beneficiary in such amounts as the trustee deems advisable. On the death of the last to die of A and B, the trust is to terminate and the corpus is to be distributed in two equal shares, one share to the descendants of each child, per stirpes. Prior to the due date for filing the Form 706, T's executor, pursuant to applicable state law, divides Trust into two separate trusts, Trust 1 and Trust 2. Trust 1 provides that income is to be paid in such amounts as the trustee deems advisable to A and A's descendants. In addition, the trustee may distribute corpus to any trust beneficiary in such amounts as the trustee deems advisable. On the death of A. Trust 1 is to terminate and the corpus is to be distributed to the descendants of A, per stirpes, but if A dies with no living descendants, the principal will be added to Trust 2. Trust 2 contains identical provisions, except that B and B's descendants are the trust beneficiaries and, if B dies with no living descendants, the principal will be added to Trust 1. Because Trust 1 and Trust 2 provide for the same beneficiaries and the same succession of interests in the aggregate as provided in Trust, and because the severance does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation than the person or persons who held the beneficial interest in Trust, the severance constitutes a qualified severance if the requirements of section 2642(a)(3) are otherwise satisfied.

Example 4. Severance of single trust with two income beneficiaries. T's will establishes a testamentary trust (Trust) providing that Trust income is to be paid to T's children, A and B, for their joint lives. Upon the death of the first to die of A and B, the income will be paid to the survivor. At the death of the survivor of A and B, the corpus is to be distributed equally to T's grandchildren, W and X (with any then-deceased grandchild's share being paid to that grandchild's estate). W is A's child and X is B's child. Prior to the due date for filing Form 706, T's executor divides the testamentary trust equally into two separate trusts, Trust 1 and Trust 2. Trust 1 provides that trust income is to be paid to A for life and, on A's death, the remainder is to pass to W. Trust 2 provides that trust income is to be paid to B for life and the remainder on B's death to X. Because Trust 1 and Trust 2 do not provide A and B with contingent survivor income interests as provided under the terms of the original trust, Trust 1 and Trust 2 do not provide for the same succession of interests in the aggregate as provided in Trust. Therefore, the division is not a qualified severance, and Trust 1 and Trust 2 are treated as one trust. If, however, in this example, Trust 1 instead provides that trust income is to be paid to A for life and then to B (if B survives A), with remainder to W, and if Trust 2 instead provides that trust income is to be paid to B for life and then to A (if A survives B), with remainder to X, then Trust 1 and Trust 2 would provide for the same succession of interests in the aggregate as provided in Trust, and the severance would constitute a qualified severance.

Example 5. Severance of a trust with a 50% inclusion ratio. On September 1, 2004, T transfers $100,000 to a trust for the benefit of T's grandchild, GC. On a timely filed Form 709, "United States Gift (and Generation-Skipping Transfer) Tax Return," reporting the transfer, T allocates all of T's remaining GST tax exemption ($50,000) to the trust. As a result of the allocation, the applicable fraction with respect to the trust is .50 [$50,000 (the amount of GST tax exemption allocated to the trust) divided by $100,000 (the value of the property transferred to the trust)]. The inclusion ratio with respect to the trust is .50[1 -- .50]. In 2006, pursuant to authority granted under applicable state law, the trustee severs the trust into two trusts, Trust 1 and Trust 2, each of which receives a 50 percent fractional share of the total value of all trust assets at that time. Because the applicable traction with respect to the original trust is .50 and the trust was severed into two equal trusts, the trustee may designate which trust has an inclusion ratio of one, and which trust has an inclusion ratio of zero. Accordingly, in the Notice of Qualified Severance reporting the severance, the trustee designates Trust 1 as having an inclusion ratio of zero, and Trust 2 as having an inclusion ratio of one.

Example 6. Funding of severed trusts on a non pro rata basis. T's will establishes a testamentary trust (Trust) for the benefit of T's descendants, to be funded with T's stock in Corporation A and Corporation B. T dies on May 1, 2004, at which time the Corporation A stock included in T's gross estate has a fair market value of $100,000 and the stock of Corporation B included in T's gross estate has a fair market value of $200,000. On a timely filed Form 706, T's executor allocates all of T's remaining GST tax exemption ($270,000) to Trust. As a result of the allocation, the applicable fraction with respect to Trust is .90 [$270,000 (the amount of GST tax exemption allocated to the trust) divided by $300,000 (the value of the property transferred to the trust)]. The inclusion ratio with respect to Trust is .10 [1 - .90]. On August 1, 2008, when the value of the Trust assets totals $500,000, consisting of Corporation A stock worth $450,000 and Corporation B stock worth $50,000, the trustee severs Trust into two identical trusts, Trust 1 and Trust 2. The terms of the instrument severing Trust provides that Trust 1 is to be funded on a non pro rata basis with assets having a fair market value on the date of funding equal to 90% of the value of the Trust assets on that date, and Trust 2 is to be funded with assets having a fair market value on the date of funding equal to 10% of the value of the Trust assets on that date. Also on August 1, 2008, the trustee funds Trust 1 with all of the Corporation A stock and funds Trust 2 with all of the Corporation B stock. Accordingly, Trust 1 is funded with assets having a value equal to 90% of the value of Trust as of the date of funding, August 1, 2008, and Trust 2 is funded with assets having a value equal to 10% of the value of Trust as of the date of funding. Therefore, if the requirements of section 2642(a)(3) are otherwise satisfied, the severance constitutes a qualified severance. Trust 1 will have an inclusion ratio of zero and Trust 2 will have an inclusion ratio of one.

Example 7. Severance of a trust along family lines. T dies on October 1, 2004. T's will establishes a testamentary trust (Trust) to be funded with $1,000,000. Trust income is to be paid to T's child, S, for S's life. On S's death, Trust is to terminate and the assets are to be divided equally among T's three grandchildren, GC1, GC2, and GC3 (or their respective descendants, per stirpes). On a timely filed Form 706, T's executor allocates all of T's remaining GST tax exemption ($300,000) to Trust. As a result of the allocation, the applicable fraction with respect to the trust is .30 [$300,000 (the amount of GST tax exemption allocated to the trust) divided by $1,000,000 (the value of the property transferred to the trust)]. The inclusion ratio with respect to the trust is .70 [1 - .30]. On June 1, 2007, the trustee determines that it is in the best interest of the beneficiaries to sever Trust to provide a separate trust for each of T's three grandchildren and their respective families. The trustee severs Trust into two identical trusts, Trust 1 and Trust 2, each trust providing that trust income is to be paid to S, for life, and on S's death, the trust is to terminate and the assets are to be divided equally among GC1, GC2, and GC3 (or their respective descendants, per stirpes). The terms of the instrument severing Trust provide that Trust 1 is to receive 30% of the Trust assets and Trust 2 is to receive 70% of the Trust assets. Further, each trust is to be funded with a pro rata portion of each asset held in Trust. The trustee then severs Trust 1 into three equal trusts, Trust GC1, Trust GC2, and Trust GC3. Each trust is named for a grandchild of T and provides that trust income is to be paid to S for life, and on S's death, the trust is to terminate and the trust proceeds distributed to the respective grandchild for whom the trust is named. If that grandchild has predeceased the termination date, the trust proceeds are to be distributed to that grandchild's then-living descendants, per stirpes, or, if none, to the other grandchildren (or their respective then-living descendants, per stirpes). Each trust is to be funded with a pro rata portion of each Trust 1 asset. The trustee also severs Trust 2 in a similar manner, into Trust GC1 (2), Trust GC2(2), and Trust GC3(2). If the requirements of section 2642(a)(3) are otherwise satisfied, the severance of Trust into Trust 1 and Trust 2, the severance of Trust 1 into Trust GC1, Trust GC2, Trust GC3, and the severance of Trust 2 into Trust GC1(2), Trust GC2(2) and Trust GC3(2), constitute qualified severances. Trust GC1, Trust GC2, Trust GC3 will each have an inclusion ratio of zero and Trust GC1(2), Trust GC2(2), and Trust GC3(2) will each have an inclusion ratio of one.

5. **Proposed Regulations on the Predeceased Parent Rule**. Section 2561(e) of the Code (enacted in 1997) contains the predeceased parent exception. If an individual is a descendant of a parent of the transferor (or the transferor's spouse or former spouse), and the individual's parent (who is also such a descendant), died prior to the time the transferor is subject to estate or gift tax on the transfer from which the individual's interest is derived, then the individual is treated as if he or she is one generation below the lower of either the transferor's generation or

the generation of the individual's youngest living lineal ancestor who is also a descendant of the parent of the transferor (or spouse or former spouse). But the exception does not apply to a transfer to an individual who is not a lineal descendant of the transferor (or spouse or former spouse) IF the transferor (or spouse or former spouse) has any living lineal descendant at the time of the transfer.

On September 2, 2004 the IRS issued proposed regulations dealing with this exception. REG-145988-03. The proposed regulations deal with several issues. First, an individual's interest in property or a trust is derived when the transferor is subject to transfer tax or, if there are multiple transfer taxes, at the first such occasion. However, a remainder interest in a QTIP is deemed to have been derived as of the death of the transferor's spouse rather than the death of the transferor. Second, although in general adoption cannot affect an individual's generation assignment (e.g. adoption by grandparent of an adult grandchild does not affect the grandchild's generation assignment because the rule is that an individual is assigned to the lowest generation where multiple assignments are possible), if an adopting parent adopts an individual who is a descendant of a parent of adopting parent (or the adopting parent's spouse or former spouse) who is under the age of 18 at the time of adoption then the adopted individual will be treated as a member of the generation that is one generation below the adopting parent when determining whether a transfer from the adopting parent (or spouse or former spouse or lineal descendant of a grandparent of the adopting parent) to the adopted individual is subject to GST tax. Further, an adjustment to such individual's generation assignment causes a corresponding adjustment to the assignment of the individual's spouse, former spouse, descendants, and spouses and former spouses of descendants.

The 90 day rule continues to apply. Further, if a transferor adds property to a trust assignments with respect to which are affected by this exception, the addition is treated as held in a separate trust for application of these rules.

The proposed regulations provide these examples:

> Example 1. T establishes an irrevocable trust, Trust, providing that trust income is to be paid to T's grandchild, GC, for 5 years, At the end of the 5-year period or on GC's prior death, Trust is to terminate and the principal is to be distributed to GC if GC is living or to GC's children if GC has died. The transfer that occurred on the creation of the trust is subject to the tax imposed by chapter 12 of the Internal Revenue Code and, at the time of the transfer, T's child, C, who is a parent of GC, is deceased. GC is treated as a member of the generation that is one generation below T's generation. As a result, GC is not a skip person and Trust is not a skip person. Therefore, the transfer to Trust is not a direct skip. Similarly, distributions to GC during the term of Trust and at the termination of Trust will not be GSTs.
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> Example 2. On January 1, 2004,T transfers $100,000 to an inter vivos trust that provides T with an annuity payable for four years or until T's prior death. The annuity satisfies the definition of a qualified interest under section 2702(b). When the trust terminates, the corpus is to be paid to T's grandchild, GC. The transfer is subject to the tax imposed by chapter 12 of the Internal Revenue Code and, at the time of the transfer, T's child, C, who is a parent of GC, is living. C

dies in 2006. In this case, C was alive at the time the transfer by T is subject to the tax imposed by chapter 12 of the Internal Revenue Code. Therefore, section 2651(e) and paragraph (a)(1) of this section do not apply. When the trust subsequently terminates, the distribution to GC is a taxable termination.

Example 3. T dies testate in 2002, survived by T's spouse, S, their children, C1 and C2, and C1's child, GC. Under the terms of T's will, a trust is established for the benefit of S and their descendants. Under the terms of the trust, all income is payable to S during S's lifetime and the trustee may distribute trust corpus for S's health, support and maintenance. At S's death, the corpus is to be distributed, outright, to C1 and C2. If either C1 or C2 has predeceased S, the deceased child's share of the corpus is to be distributed to that child's descendants, per stirpes. The executor of T's estate makes the election under section 2056(b)(7) to treat the trust property as qualified terminable interest property (QTIP) but does not make the election under section 2652(a)(3) (reverse QTIP election). In 2003, C1 dies survived by S and GC. In 2004, S dies, and the trust terminates. The full fair market value of the trust is includible in S's gross estate under section 2044 and S becomes the transferor of the trust under section 2652(a)(1)(A). Under the rule in paragraph (a)(3) of this section, GC's interest is considered established or derived at S's death, and because C1 is deceased at that time, GC is treated as a member of the generation that is one generation below the generation of the transferor, S. As a result, GC is not a skip person and the transfer to GC is not a direct skip.

Example 4. The facts are the same as in Example 3. However, the executor of T's estate makes the election under section 2652(a)(3) (reverse QTIP election) for the entire trust. Therefore, T remains the transferor because, for purposes of chapter 13 of the Internal Revenue Code, the election to be treated as qualified terminable interest property is treated as if it had not been made. In this case, the rule in paragraph (a)(3) of this section does not apply, so GC's interest is established or derived on T's death in 2002. Because C1 was living at the time of T's death, the predeceased parent rule under section 2651(e) does not apply, even though C1 was deceased at the time the transfer from S to GC is subject to the tax under chapter 11 of the Internal Revenue Code. When the trust terminates, the distribution to GC is a taxable termination that is subject to the GST tax to the extent the trust has an inclusion ratio greater than zero. See section 2642(a).

Example 5. T establishes an irrevocable trust providing that trust income is to be paid to T's grandniece, GN, for 5 years or until GN's prior death. At the end of the 5-year period or on GN's prior death, the trust is to terminate and the principal is to be distributed to GN if living, or if GN has died, to GN's descendants, per stirpes. S is a sibling of T and the parent of N. N is the parent of GN. At the time of the transfer, T has no living lineal descendant, S is living, N is deceased, and the transfer is subject to the gift tax imposed by chapter 12 of the Internal Revenue Code. GN is treated as a member of the generation that is one generation below T's generation because S, GN's youngest living lineal ancestor who is also a descendant of T's parent, is in T's generation. As a result, GN is not a skip person and the transfer to the trust is not a direct skip. In addition, distributions to GN during the term of the trust and at the termination of the trust will not be GSTs.

Example 6. On January 1, 2004, T transfers $50,000 to the great grandchild, GGC, of B, a brother of T. At the time of the transfer, B's grandchild, GC, who is a parent of GGC and a child of B's living child, C, is deceased. GGC will be

> treated as a member of the generation that is one generation below the lower of T's generation or the generation assignment of GGC's youngest living lineal ancestor who is also a descendant of the parent of the transferor. In this case, C is GGC's youngest living lineal ancestor who is also a descendant of the parent of T. Because C's generation assignment is lower than T's generation, GGC will be treated as a member of the generation that is one generation below C's generation assignment (i.e., GGC will be treated as a member of GC's generation). As a result, GGC remains a skip person and the transfer to GGC is a direct skip.

6. **Alternate Method for Making Late Allocations of GST Exemption**. Rev. Proc. 2004-46, 2004-31 IRB 142, provides a simplified method for obtaining an extension to make a late allocation of GST exemption , effective August 2, 2004. The taxpayer may file a Form 709 for the year of the transfer to the trust for which the late allocation is being made, with a statement at the top of the Form that it is "FILED PURSUANT TO REV. PROC. 2004-46." The Form 709 should report the property transferred and contain a Notice of Allocation with the trust identified, the value of the property given (as of the date of the transfer), the amount of the taxpayer's unused GST exemption, the amount allocated to this transfer, the inclusion ratio of the trust after the transfer and a statement that the taxpayer was eligible to make a late allocation.

Only certain taxpayers are eligible. The transfer must have been made prior to December 31, 2000. No taxable distributions nor terminations must have occurred prior to the request to make a late allocation. The transfer must have qualified for the annual exclusion and the total gifts to that donee must not have exceeded the amount of the annual exclusion. No GST exemption must have been allocated to the transfer and the taxpayer must have unused GST exemption available to allocate.

If a taxpayer does not qualify the taxpayer may still ask for relief but must do so by letter ruling request under Ss 301.9100-3 (as described in Rev. Proc. 2004-1).

7. **Alternate Method to Make Late Reverse QTIP Election**. Rev. Proc. 2004-47, 2004-32 IRB 169 (August 5, 2004) sets forth a simplified method of electing reverse QTIP treatment late. Normally the transferor's spouse (the surviving spouse) will be the transferor of a QTIP trust for GST purposes with the result that any allocation of GST exemption made to the QTIP at the first spouse's death will be wasted. Section 2652(a)(3) provides that the executor may elect for GST purposes to treat the decedent as the transferor and that is called a "reverse QTIP election." That election allows the decedent's GST exemption to be allocated to the QTIP or a part of the QTIP. The reverse QTIP election must be made on a timely filed Form 706 (including extensions). If the election is not timely made, then the IRS may grant relief under section 9100. Previously the request for relief has come in the form of a private letter ruling.

The Revenue Procedure allows a simplified method but may be used only if: (1) a valid QTIP election was made, (2) no reverse QTIP election was made, (3) the decedent has sufficient GST exemption remaining to result in a zero-inclusion ratio for the trust; (4) there is no automatic six month extension available; (5) the surviving spouse has not disposed of all or a part of the QTIP income interest; and (6) the surviving spouse is alive or not more than six months have passed since his or her death.

The request will contain copies of Parts 1 - 5 and Schedule M of the original Form 706, a completed Schedule R, and a statement describing why the election was not made on the Form 706 as filed. A cover sheet will be provided which has at the top "REQUEST FOR EXTENSION Filed Pursuant to Rev. Proc. 2004-47." In addition, the there must be a signed statement from the qualified tax professional on whom the taxpayer relied when preparing the original Form 706, and a signed statement from the executor, attesting to the accuracy of the filing, including, of course, the explanation.

The Revenue Procedure does not allow retroactive allocations of exemption or trust severances. If the relief sought is not granted the taxpayer may file a ruling request. Such a request approving a severance is PLR 200502036 (pro rata division of assets).

8. **Election Out of GST Deemed Allocations; § 2632 Proposed Regulations**. Section 2632 provides for allocations of GST exemption, including certain automatic allocations. The IRS has issued proposed regulations dealing with those allocations. REG-153841-02. The Background to the proposed regulations described the automatic allocation rules as follows:

> Section 2632 also provides deemed allocation rules pursuant to which an individual's available GST exemption is automatically allocated to certain kinds of transfers, without any action on the part of the transferor. Under section 2632(b), an individual's unused GST exemption is automatically allocated to transfers made during that individual's lifetime that are direct skips as defined in section 2612(c), to the extent necessary to make the inclusion ratio zero for the property transferred. Under section 2632(c), in the case of a lifetime transfer made after December 31, 2000 that is an indirect skip, the transferor's available GST exemption is automatically allocated to the transfer to the extent necessary to make the inclusion ratio zero for the property transferred. Section 2632(c)(3)(A) defines an indirect skip as a transfer of property (other than a direct skip) subject to gift tax that is made to a GST trust. A GST trust is defined in section 2632(c)(3)(B), in general, as any trust that could have a generation-skipping transfer. However, no trust described in section 2632(c)(3)(B)(i) through (vi) is treated as a GST trust, because a sufficient possibility exists (based on the statutory criteria) that the trust corpus will not be distributed to lower generations. A transfer to any trust described in section 2632(c)(3)(B)(i) through (vi) will not be subject to the automatic allocation of the GST exemption. The automatic allocation under section 2632(c) also applies to an indirect skip occurring upon the post-2000 termination of an estate tax inclusion period.
>
> Under section 2632(c)(5)(A)(i)(I), an individual may elect out of the deemed allocation rules so that GST exemption will not be allocated automatically to a particular transfer that is an indirect skip. Under section 2632(c)(5)(B)(i), this election out with regard to a particular indirect skip shall be deemed timely if made on a timely filed gift tax return for the calendar year in which the transfer was made, or deemed to have been made under section 2632(c)(4) with regard to

trusts subject to an estate tax inclusion period, or on such later dates as may be prescribed in regulations.

Under section 2632(c)(5)(A)(i)(II), an individual may elect out of the deemed allocation rules for indirect skips so that GST exemption will not be allocated automatically to any or all transfers made to the trust by that individual, regardless of when a transfer is, or may in the future be, made. Under section 2632(c)(5)(B)(ii), this election out with regard to any or all transfers to the trust by that individual may be made on a timely filed gift tax return for the calendar year for which the election is to become effective.

Alternatively, under section 2632(c)(5)(A)(ii), an individual may elect to treat any trust as a GST trust with regard to any or all transfers made by that individual to the trust. If this election is made, the rules for the automatic allocation of the GST exemption will apply with regard to that individual's transfers to the trust, notwithstanding that the trust is described in section 2632(c)(3)(B)(i) through (vi). Under section 2632(c)(5)(B)(ii), the election to treat a trust as a GST trust may be made on a timely filed gift tax return for the calendar year for which the election is to become effective.

The proposed regulations were summarized by the Background:

Under the proposed regulations, the election out of the automatic allocation rules for indirect skips and the election to treat any trust as a GST trust are to be made on a timely filed federal gift tax return.

Under the proposed regulations, a transferor who wants to elect out of the automatic allocation rules for indirect skips has the option of electing out for the specific transfer to the GST trust, or making a single election with regard to the trust that applies to the current transfer and all subsequent transfers made by that transferor to the trust. Under the second option, once the election is made with regard to a trust, the election remains effective for all subsequent transfers to that trust by the electing transferor, until that transferor's election is terminated. Practitioners have commented that in many cases, particularly situations in which trust corpus consists of primarily insurance contracts, the transferor may not be required to file a Federal gift tax return reporting annual transfers to a GST trust because the transfers qualify for the gift tax annual exclusion under section 2503(b). If under the terms of the trust instrument distributions to skip persons are unlikely, the transferor may choose not to allocate GST exemption to the trust. The rule in the proposed regulation is intended to alleviate the need to repeatedly file a gift tax return to elect out of the automatic allocation rules for transfers that would not otherwise require a Federal gift tax return to be filed. Thus, once the transferor "elects out" of the automatic allocation rule for indirect skips with regard to any or all transfers made by that transferor to the trust, the election out, until terminated, remains effective for all subsequent transfers made by that transferor to the trust, without any further reporting requirement on the part of the transferor. A similar rule applies with regard to the election to treat a trust as a GST trust.

The proposed regulations contain five examples:

Example 1. Modification of allocation of GST exemption. On December 1, 2003, T transfers $1 00,000 to an irrevocable GST trust described in section

2632(c)(3)(B). The transfer to the trust is not a direct skip. The date prescribed for filing the gift tax return reporting the taxable gift is April 15, 2004. On February 10, 2004, T files a Form 709 on which T properly elects out of the automatic allocation rules contained in section 2632(c)(1) with respect to the transfer in accordance with paragraph (b)(2)(ii) of this section, and allocates $50,000 of GST exemption to the trust. On April 13th of the same year, T files an additional Form 709 on which T confirms the election out of the automatic allocation rules contained in section 2632(c)(1) and allocates $100,000 of GST exemption to the trust in a manner that clearly indicates the intention to modify and supersede the prior allocation with respect to the 2003 transfer. The allocation made on the April 13 return supersedes the prior allocation because it is made on a timely-filed Form 709 that clearly identifies the trust and the nature and extent of the modification of GST exemption allocation. The allocation of $100,000 of GST exemption to the trust is effective as of December 1, 2003. The result would be the same if the amended Form 709 decreased the amount of the GST exemption allocated to the trust.

Example 2. Modification of allocation of GST exemption. The facts are the same as in Example 1, except on July 8, 2004, T files a Form 709 attempting to reduce the earlier allocation. The return is not a timely filed return. The $100,000 GST exemption allocated to the trust, as amended on April 13, 2004, remains in effect because an allocation, once made, is irrevocable and may not be modified after the last date on which a timely filed Form 709 can be filed.

Example 3. Effective date of late allocation of GST exemption. On December 1, 2003, T transfers $100,000 to an irrevocable GST trust described in section 2632(c)(3)(B). The transfer to the trust is not a direct skip. The date prescribed for filing the gift tax return reporting the taxable gift is April 15, 2004. On February 10, 2004, T files a Form 709 on which T properly elects out of the automatic allocation rules contained in section 2632(c)(1) in accordance with paragraph (b)(2)(ii) of this section with respect to that transfer. On December 1, 2004, T files a Form 709 and allocates $50,000 to the trust. The allocation is effective as of December 1, 2004.

Example 4. Effective date of late allocation of GST exemption. T transfers $100,000 to a GST trust on December 1, 2003, in a transfer that is not a direct skip. On April 15, 2004, T files a Form 709 on which T properly elects out of the automatic allocation rules contained in section 2632(c)(1) with respect to the entire transfer in accordance with paragraph (b)(2)(ii) of this section and T does not make an allocation of any GST exemption on the Form 709. On September 1, 2004, the trustee makes a taxable distribution from the trust to T's grandchild in the amount of $30,000. Immediately prior to the distribution, the value of the trust assets was $150,000. On the same date, T allocates GST exemption to the trust in the amount of $50,000. The allocation of GST exemption on the date of the transfer is treated as preceding in point of time the taxable distribution. At the time of the GST, the trust has an inclusion ratio of .6667 (1-(50,000/150,000)).

Example 5. Automatic allocation to split-gift. On December 1, 2003, T transfers $50,000 to an irrevocable GST Trust described in section 2632(c)(3)(B). The transfer to the trust is not a direct skip. On April 30, 2004, T and T's spouse, S, each files an initial gift tax return for 2003, on which they consent, pursuant to section 2513, to have the gift treated as if one-half had been made by each. Previously, neither T nor S filed a timely gift tax return electing out of the automatic allocation rules contained in section 2632(c)(1). As a result of the

> election under section 2513, which is retroactive to the date of T's transfer, T and S are each treated as the transferor of one-half of the property transferred in the indirect skip. Thus, $25,000 of T's unused GST exemption and $25,000 of S's unused GST exemption is automatically allocated to the trust. Both allocations are effective on and after the date that T made the transfer. The result would be the same if T's transfer constituted a direct skip subject to the automatic allocation rules contained in section 2632(b).

PLR 200512003 is a ruling under the proposed regulations. The trust in question provided for a child to receive the income from the child's share of the trust upon the child reaching age 35 and receive the principal outright at age 50. The donors intended to elect out of the automatic allocation but the accountant failed to realize that a written election out was required.

In PLR 200510026 the IRS determined that a late allocation could be made to a trust which was to last for 21 years beyond the lifetimes of the taxpayer, the taxpayer's spouse, and the taxpayer's then living descendants. The Form 709 was filed with Schedule C left blank. The trust contained language indicating the trust was to be a generation-skipping trust.

Q. SECTIONS 2701-2704 - SPECIAL VALUATION RULES

1. **Family Limited Partnerships**. Taxpayers have won arguments that neither section 2703 nor 2704(b) apply (but see the section 2036 discussion above).

2. **Final Regulations Describing Qualified Unitrust or Annuity Trust Interest**. The IRS has issued final regulations under section 2702 describing a qualified annuity or unitrust interest. T. D. 9181 (February 25, 2005). The new regulations conform to the Walton decision and allow a GRAT to be zeroed-out by having annuity payments made to the grantor/annuitant's estate if he or she dies during the stated term. However, the regulations were changed to limit the usefulness of a revocable spousal interest as described in the Schott and Cook decisions; this change is primarily of retrospective interest because of the availability of Walton type GRATs.

3. **Effect on Buy-Sell Agreement**. The Tax Court disregarded a buy-sell agreement in Estate of George C. Blount v. Commissioner, T.C. Memo 2004-116, in determining the value of closely-held stock (BBC). The court found that the agreement allowed the decedent to amend it unilaterally, thus the agreement's restrictions on lifetime transfers could have been eliminated and under pre-section 2703 law the buy-sell was ineffective to set the price of shares subject to it. Further, in 1996 the agreement was amended, thus blowing the section 2703 grandfather.

The court also addressed the effect of life insurance payable to the company and the corporate obligation to redeem stock from the decedent's estate:

> We turn next to the question of how to account for the $3,146,134 million in life insurance proceeds BCC was due to receive on decedent's death and BCC's $4

million obligation to redeem decedent's shares, as set forth in the Modified 1981 Agreement. Mr. Fodor excluded both the insurance proceeds and the redemption obligation when determining BCC's value on the theory that the insurance proceeds were offset by the redemption obligation. In contrast, Mr. Hitchner included the insurance proceeds in valuing BCC, adding their value to his $7 million "concluded" value for BCC, while disregarding the redemption obligation.

Respondent argues that the insurance proceeds must be included in BCC's value as a nonoperating asset, relying on section 20.2031-2(f), Estate Tax Regs., and Estate of Huntsman v. Commissioner, 66 T.C. 861 (1976). In contrast, the estate argues that, while insurance proceeds might be a nonoperating asset, under Estate of Cartwright v. Commissioner, 183 F.3d 1034 (9th Cir. 1999), affg. in part and remanding in part T.C. Memo. 1996-286, they must be offset by BCC's obligation to redeem decedent's shares, and therefore do not affect BCC's value.

Estate of Huntsman makes clear that insurance proceeds are treated like any other nonoperating asset when determining a closely held corporation's value. Estate of Huntsman v. Commissioner, supra at 874; see also sec. 20.2031-2(f), Estate Tax Regs. (" consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such nonoperating assets have not been taken into account in the determination of net worth, prospective earning power and dividend-earning capacity"). Whether BCC's $4 million obligation to redeem decedent's shares offsets the life insurance proceeds, as the estate argues, is another question. In Estate of Huntsman, we reasoned that, because life insurance proceeds should be treated like any other nonoperating asset, to the extent such assets were considered in valuing a company, they were subject to offset by corporate liabilities. However, we were not presented in that case with the question of whether a corporation's obligation to redeem the very shares that are to be valued should be treated as a liability, offsetting corporate assets.34 The estate here urges that we treat BCC's enforceable $4 million obligation to redeem the shares whose value is at issue as a liability offsetting BCC's assets (i.e., the $3,146,134 life insurance proceeds plus almost $1 million in other assets) in arriving at the value of the same shares.

We decline to do so for two reasons. First, we have concluded that the agreement under which BCC was obligated to redeem decedent's shares for $4 million must be disregarded under both section 20.2031-2(h), Estate Tax Regs., and section 2703. In such circumstances, the terms of the disregarded agreement are generally not taken into account in determining the fair market value of the shares subject to the agreement. Estate of True v. Commissioner, T.C. Memo. 2001-167; Estate of Lauder v. Commissioner, T.C. Memo. 1994-527; see also Estate of Godley v. Commissioner, T.C. Memo. 2000-242, affd. 286 F.3d 210 (4th Cir. 2002). As we noted in Estate of Lauder, under these circumstances, the willing buyer/seller analysis would be distorted if we disregarded the buy-sell agreement for purposes of fixing the value of the subject stock, yet allowed provisions in the agreement to be taken into account when determining the stock's fair market value. Thus, it would be improper here to consider the redemption obligation in the disregarded buy-sell agreement when determining the fair market value of the stock covered by that agreement.

Second, even if the impact of the redemption obligation on BCC's value were not disregarded under the principles of Estate of Lauder and like cases, the redemption obligation should not be treated as a value-depressing corporate liability when the very shares that are the subject of the redemption obligation are being valued. To do so would be to value BCC in its postredemption configuration; namely, after decedent's shares had been redeemed and BCC's assets had been contracted by the $4 million redemption payment. Valuing decedent's 43,080 shares by means of the hypothetical willing buyer/seller construct necessarily requires that the corporation's actual obligation to redeem the shares be ignored; such a stance is inherent in the fiction that the shares are being sold to a hypothetical third-party buyer on the valuation date rather than being redeemed by the corporation. To the hypothetical willing buyer, decedent's 43,080 BCC shares constituted an 83.2-percent interest in all of the assets and income-generating potential of BCC on the valuation date, including any assets that might be used to satisfy the actual redemption obligation. To treat the corporation's obligation to redeem the very shares that are being valued as a liability that reduces the value of the corporate entity thus distorts the nature of the ownership interest represented by those shares.

By contrast, a hypothetical willing buyer of BCC shares other than decedent's would treat the redemption obligation, on the valuation date, as a corporate liability of BCC, but only in connection with a simultaneous accounting of the impact of the redemption of decedent's shares on the ownership interest inherent in the other shares not being redeemed.

A simplified example will illustrate the fallacy behind the estate's contention that BCC's obligation to redeem decedent's shares should be treated as a liability offsetting a corresponding amount of corporate assets. Assume corporation X has 100 shares outstanding and two shareholders, A and B, each holding 50 shares. X's sole asset is $1 million in cash. X has entered into an agreement obligating it to purchase B's shares at his death for $500,000. If, at B's death, X's $500,000 redemption obligation is treated as a liability of X for purposes of valuing B's shares, then X's value becomes $500,000 ($1 million cash less a $500,000 redemption obligation). It would follow that the value of B's shares (and A's shares) is $250,000 (i.e., one half of the corporation's $500,000 value35) upon B's death. Yet if B's shares are then redeemed for $500,000, A's shares are then worth $500,000 -- that is, A's 50 shares constitute 100-percent ownership of a corporation with $500,000 in cash.

It cannot be correct either that B's one-half interest in $1 million in cash is worth only $250,000 or that A's one-half interest in the remainder shifts from a value of $250,000 preredemption to a value of $500,000 postredemption.

The error with respect to B's shares in the example lies in the treatment of X's redemption obligation as a claim on corporate assets when valuing the very shares that would be redeemed with those assets. With respect to A's shares, a willing buyer would pay $500,000 upon B's death (not $250,000) because he would take account of both the liability arising from X's redemption obligation and the shift in the proportionate ownership interest of A's shares occasioned by the redemption -- but never the former without the latter.36

The estate's reliance on Estate of Cartwright v. Commissioner, 183 F.3d 1034 (9th Cir. 1999), is misplaced, as that case is distinguishable. Estate of Cartwright involved a law firm (organized as a C corporation) that entered into a buy-sell agreement with its majority shareholder. The parties agreed that the firm would purchase from the shareholder's estate his shares and his interest in the fees for the firm's work in progress at his death. The consideration for this purchase was designated as the proceeds from two \$2.5 million life insurance policies on the shareholder's life that the firm was required to obtain under the agreement.

Upon the shareholder's death, the firm paid the \$5,062,02937 insurance proceeds to the shareholder's estate. The taxpayer took the position that the entire \$5,062,029 was paid for the shareholder's stock, whereas the Commissioner determined that approximately \$4 million was paid for the shareholder's interest in work in progress (and, therefore, was income in respect of a decedent). Concluding that the insurance proceeds were consideration for both the stock and the shareholder's interest in work in progress, this Court undertook to allocate the consideration between the two by determining the stock's fair market value at the shareholder's death, and treating the insurance proceeds in excess of that fair market value as consideration paid for the shareholder's interest in work in progress. In determining the fair market value of the stock, we rejected the taxpayer's argument that the \$5 million in insurance proceeds should be treated as a nonoperating asset of the firm, augmenting the value of its stock, on the grounds that the insurance proceeds were offset by the firm's obligation to pay them over to the estate. In so concluding, we relied on Estate of Huntsman v. Commissioner, 66 T.C. 861 (1976), as follows: "We said in Estate of Huntsman that a buyer would not pay more for stock based on the corporation's ownership of life insurance if the proceeds would be largely offset by the corporation's liabilities. That is the case here." Estate of Cartwright v. Commissioner, T.C. Memo. 1996-286 (citation omitted). The Court of Appeals for the Ninth Circuit affirmed our position that the life insurance proceeds would not be considered by a hypothetical willing buyer in these circumstances. Estate of Cartwright v. Commissioner, 183 F.3d at 1038.

Estate of Cartwright is distinguishable. The lion's share of the corporate liabilities in that case which were found to offset the insurance proceeds were not obligations of the corporation to redeem its own stock. Rather, we determined that approximately \$4 million of the \$5 million liability of the corporation was to compensate the decedent shareholder for services; i.e., for his interest in work in progress. Thus, a substantial portion of the liability was no different from any third-party liability of the corporation that would be netted against assets, including insurance proceeds, to ascertain net assets.

Concededly, a portion of the liability in Estate of Cartwright constituted an obligation to redeem stock being valued. Nonetheless, in contrast to the instant case, the buy-sell agreement in Estate of Cartwright had not been disregarded pursuant to section 20.2031-2(h), Estate Tax Regs., or section 2703; indeed, our principal task in Estate of Cartwright was to construe the terms of the buy-sell agreement, which was fully respected. Given the disregarded status of the buy-sell agreement at issue here, Estate of Cartwright has no application.

Accordingly, we conclude that the \$3,146,134 in insurance proceeds due BCC upon decedent's death should be treated as a nonoperating asset of BCC and is not offset by BCC's \$4 million obligation to redeem decedent's shares.

Not decided under section 2703, but having great relevance to it, is Estate of H. A. True, Jr. v. Commissioner, 390 F. 3d 1210 (10th Cir. 2004) which dealt with the application of buy-sell agreements to value under section 2031 in a pre-2703 context. The court noted that section 2703 essentially codified the rules it applied.

The decedent, his wife, and three sons owned six companies, four were involved in oil and gas exploration, marketing, and transportation and the other two were ranches. Over a long period of time interests in the businesses were transferred and each were subject to essentially the same kind of buy-sell arrangement which set a purchase price of book value (sometimes excluding particular assets). The court found that a buy-sell would set the value of assets for estate and gift tax purposes if the price is determinable from the agreement, the agreement is binding through life and at death, the agreement is legally binding and enforceable, and was entered into for bona fide business reasons and not as a testamentary substitute. It was the final test which was at issue.

The court held that the buy-sells were testamentary substitutes.

> As we have pointed out, where the price term in a buy-sell agreement is reached in an arbitrary manner, is not based on an appraisal of the subject interest, or is done without professional guidance or consultation, courts draw an inference that the buy-sell agreement is a testamentary substitute. *See Cameron W. Bommer Revocable Trust*, T.C.M. (RIA) 97380 at 2425 (inference of testamentary device where decedent failed to obtain professional appraisal for properties and did nothing more than consult attorney who came up with price term in one day for interests listed in buy- sell agreement); *Lauder II*, T.C.M. (RIA) 92736 at 3732 (price term reached after only informal consultation with close family financial advisor and without any formal appraisals of company); *cf. Estate of Gloeckner*, 152 F.3d at 216 (inference of testamentary intent diminished, in part, by fact that decedent hired independent accountant to value stock listed in buy-sell agreement). Here, Dave True sought only a limited amount of professional advice in determining to use the tax book value for the price terms in the buy-sell agreements, and he did not substantially rely on any independent appraisals in doing so.
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> Cloyd Harris, a long time friend and accountant of the True family and their companies, testified that Dave wanted to pick a value that "was easily determined, without having to hire appraisers and oil field engineers and so on to come up with a valuation." Rec., vol. II at 233. In discussions with Dave about the manner in which he might bring his children into the family businesses, id. at 228, Mr. Harris said he did not object to the use of tax book value in the buy-sell agreements. Id. at 232. Nevertheless, he did express some concern that when valuing the different True companies as stand-alone operations, "it would be very hard to justify book value or income tax basis value as fair market value. . . . If [one] were looking at a liquidating situation, then it would not have been a true value, but [the True companies were] an ongoing operating situation." Id. at 233-34. Mr. Harris believed "book value was not out of line," id. at 234, as a method of pricing the interests in the buy-sell agreements.
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> Dave True did obtain one appraisal in connection with his 1973 gift of True Oil to his children. See Estate of True, 82 T.C.M. (CCH) at 40; rec., vol. II at 205-06. However, the record indicates that at most the appraisal of True Oil was obtained and reviewed for litigation purposes during the 1973 gift tax case, rec., vol. II at 206, and was not relied upon by the children when entering into the agreements with their father. Id. at 328. Nor do taxpayers present evidence of any other appraisals obtained in connection with the children's subsequent entry into buy-sell agreements with their parents for the other True companies. Therefore, for the majority of interests at issue here, there were no outside evaluations of the value of the companies for the purpose of determining whether

their fair market value was adequately represented by the price terms in the buy-sell agreements. In similar fashion to the courts in Cameron W. Bommer Revocable Trust and Lauder II, which expressed concern regarding experienced businessmen setting price terms in buy-sell agreements with only the most limited of professional advice, Cameron W. Bommer Revocable Trust, T.C.M. (RIA) 97380 at 2425; Lauder II, T.C.M. (RIA) 92736 at 3732, we agree with the tax court's determination that the manner by which Dave True selected the price terms for the buy-sell agreements contributes to a finding that the agreements were testamentary substitutes.

The court in Lauder II also noted that where the price term in a buy-sell agreement excluded the value of intangible assets, a further inference could be drawn that the agreement in question served a testamentary purpose. Id. Here, the nature of tax book value accounting for True Oil allowed the company's proven oil and gas reserves to be omitted "because the reserves were essentially purchased with earnings from the other True companies and their value likely would be dissipated in the unsuccessful search for replacement reserves." Estate of True, 82 T.C.M. (CCH) at 69; see also id. at 63, 70-71; rec., vol. II at 234-43. Hence,

> while we appreciate that an adjusted book value formula may provide a simple and inexpensive means for evaluating shares in a company, we cannot passively accept such a formula where, as here, it appears to have been adopted in order to minimize or mask the true value of the [interests] in question.

Lauder II, T.C.M. (RIA) 92736 at 3732.

Another factor considered by the tax court in making its testamentary purpose determination was that the buy-sell agreements did not contain within their provisions a mechanism by which to reevaluate the price terms listed therein. See, e.g., Cameron W. Bommer Revocable Trust, T.C.M. (RIA) 97380 at 2424, 2426 (lack of periodic revaluation of price term one factor contributing to conclusion that buy-sell agreement was testamentary substitute). The tax court concluded, and we agree, that unrelated parties negotiating at arm's length would likely have required a periodic reevaluation of the use of tax book accounting to value the interests in the buy-sell agreements. As Mr. Harris testified, keeping True Oil's books on a tax value accounting method and employing the accelerated depreciation methods permitted thereunder took into account the company's practice of expending the value of proven oil and gas reserves to finance the costly search for new reserves. Rec., vol. II at 234-43. If the company were to cease operating in such a manner, however, the tax book value accounting method would not be the best manner by which to value the company because the values of its reserves would not be considered. One would thus expect arm's length parties to require a regular reevaluation of True Oil's pricing formula, especially to the extent it took into account or omitted the company's proven reserves. Similarly, Eighty-Eight Oil, which was labeled as one of the True companies which generated "large sums of cash," id. at 242, was nonetheless reported at a negative tax book value upon Tamma's sale of her interests in that company to her brothers and parents. Rec., ex. 154-J, attachment D. Parties operating at arm's length would have certainly required the buy-sell agreements to include within their terms a method by which to reevaluate the price terms of the company in light of such a disparity.

Additionally, when the True children entered into the buy-sell agreements, there was no negotiation between the children and their father as to the terms of the agreements. The parties discussed the agreements and the reasons for the restrictions contained therein, rec., vol. II at 81, 84, 97, 303, 321-22; id., vol. III at 432, but the children did not engage in any bargaining with their father about the terms, rec., vol. II at 303. They did not seek outside counsel to represent their interests when entering or exiting the agreements, id. at 102, 298, 299, 361-62, nor did they have any knowledge as to who drafted the agreements, id. at 362; id., vol. III at 471. Rather, they were presented with a business opportunity crafted by their father which they could accept or reject. Id. at 83-84, 132, 304; id., vol. III at 432. In Lauder II, the tax court expressed concern about a buy-sell agreement in which the family patriarch appeared to decide unilaterally the formula price for the exchanged interests. Lauder II, T.C.M. (RIA) 92736 at 3732. Similarly, in Cameron W. Bommer Revocable Trust, the tax court viewed with suspicion a buy-sell agreement that was not reached by bona fide negotiations with respect to the price terms, and in which all the parties to the agreement were represented by the same lawyer. Cameron W. Bommer Revocable Trust, T.C.M. (RIA) 97380 at 2425.

Finally, what we deem most telling are the facts surrounding Tamma's departure from the True companies. Prior thereto, her father's will generally provided that the residue of his estate would pass to Jean, with the remainder passing to his four children in equal shares upon Jean's death. Rec., ex. 14-J at 1-2. After Tamma's departure from the businesses, she was wholly excluded from any interest in her father's estate. Tamma was removed from Dave's will, id. at ex. 11-J, and was no longer listed as a beneficiary under his living trust agreement, id. at ex. 12-J, 13-J. In a document exercising a power of appointment in favor of his living trust, Dave specifically noted that Tamma's potential inheritance had been fully satisfied when she severed her financial ties with the True companies. Id. at 13-J at 4. At trial, Diemer testified he was aware his father excluded Tamma from his will after she sold her interests in the companies. He stated he and his father talked about the issue and that Dave "was very committed to keeping the businesses together, and he felt, on his death, that the cash [from the estate] would be necessary to keep-to stay in the business. And so, it was a conscious decision, I believe, since he made that comment, to make that decision." Rec., vol. II at 123.

Taxpayers also reported that at the time of his death, Dave's total estate was worth just over $120 million, forty-four percent of which represented the reported value attributable to Dave's interests in the True companies. Aplt. supp. br. at 2, 7.11 If, as taxpayers contend, the buy-sell agreements were not testamentary substitutes, Tamma likely would have been excluded only from that percentage of her father's estate relating to his interests in the True companies. Instead, she garnered no benefit from her father's estate, not even from the portion not directly associated with the True companies.

Like the court deciding Estate of Godley, in which the decedent indicated in a deposition prior to his death that the transfer of certain interests to his son was a gift executed for the purpose of circumventing estate tax liability, Estate of Godley, 80 T.C.M. (CCH) at 161, we have trouble ignoring Dave's own statement in exercising his power of appointment that Tamma's inheritance had been satisfied by the sale of her interests in the True companies. Diemer's testimony supporting the same position, as well as Tamma's exclusion from the large percentage of her father's reported estate values not associated with the

True companies, clearly support an inference that the buy-sell agreements served as testamentary substitutes for Dave True.

The court noted that there <u>were</u> factors to the contrary but obviously gave little weight to them. Footnote 10 states:

> We acknowledge that factors such as the decedent's health, the consistent enforcement of the agreements, and the binding of all parties equally regardless of who died first, weigh in favor of taxpayers' argument that the buy-sell agreements were not testamentary devices. Dave True was in good health in 1971 and 1973 when he entered into the buy-sell agreements with his children for True Oil and Belle Fourche Pipeline, and there is no indication Dave's health was in jeopardy as the children gained interests in the other family businesses. Similarly, the tax court found the True family was generally quite consistent in complying with the terms of the buy-sell agreements and executed formal waivers where deviation from the agreements' terms was appropriate. Estate of True, 82 T.C.M. (CCH) at 61. Finally, taxpayers are correct to note that the buy-sell agreements bound all the parties equally, regardless of who died first. See, e.g., Estate of Bischoff v. C.I.R., 69 T.C. 32, 41 (1977) (buy-sell agreement not testamentary device where all provisions equally applicable to all partners); Estate of Littick, 31 T.C. at 187 (where agreement equally binding on all family members regardless of who died first, no testamentary intent found). But we are not persuaded that these factors outweigh the many other indicators that the buy-sell agreements served as testamentary substitutes for Dave True. See, e.g., Lauder II, T.C.M. (RIA) 92736 at 3731-32 (court acknowledged that good health of decedent at time of entering into agreements, long period of time between execution of agreements and decedent's death, the parties' consistent adherence to the agreements, and fact that any bound party could have predeceased the others, all supported taxpayers' argument that buy-sell agreements were not testamentary substitutes; however, other factors compelled court to conclude otherwise).

R. <u>SECTION 6166 — EXTENSION OF TIME TO PAY TAX</u>

1. **<u>Ten-Year Statute of Limitations</u>**. In <u>United States v. Askegard</u>, 357 F. Supp. 2d 1152 (D. Minn. 2005) the estate disposed of various parcels of land, used in the family farm which was a closely held business, before 1991 and had the liens released on them. The value of those added to between 31% and 32% of the amount for which the election was made, rather than 33%. Thus the 10 year statute of limitations did not begin to run and the government could sue in 2001 to collect unpaid taxes and interest.

S. <u>TAX ADMINISTRATION</u>

1. **<u>Circular 230</u>**. On December 20, 2004 the IRS issued final regulations governing practice before the Internal Revenue Service, Circular 230. T. D. 9165. Additional final regulations were issued on May 19, 2005. T. D. 9201. The new rules are effective June 20, 2005 and mean that all written tax advice must be reviewed carefully for compliance.

2. **Simultaneous Work for the IRS Did Not Mean Estate Improperly Represented**. In L. Sexton, 2005-1, USTC P60,499, the attorney for an estate was also an expert for the IRS in an unrelated real estate valuation matter. Before trial in the Tax Court the judge indicated it was unlikely the estate would win; the estate's attorney advised the executor to accept a settlement and the executor agreed. Subsequently new counsel on behalf of the estate claimed that the settlement should be set aside on account of the estate attorney's conflict of interest. The Tax Court found there was no credible evidence that the attorney's employment by the IRS harmed the estate and the Ninth Circuit affirmed.

3. **Providing Tax Return to Heirs at Law**. Rev. Rul. 2004-68, 2004-31 IRB 118, provides that the income tax return of an intestate decedent for the calendar year prior to decedent's death shall be open to inspection or disclosure to any heir at law or next of kin who is a distributee of the decedent's probate estate. Further, other income tax returns may be disclosed to any heir at law or next of kin who can show he or she has a material interest which will be affected by the information in the requested return. A "material interest" is an important interest that is financial in nature.

4. **Duty of Consistency**. In Estate of Rose B. Posner v. Commissioner, T.C. Memo 2004-112, the court determined that a trust was not included in a surviving spouse's estate because she had no general power of appointment. However, when the first spouse had died, in 1975, the IRS had allowed a marital deduction thinking she did.

One of the issues was the duty of consistency, which the opinion described as follows:

> As developed in caselaw, the duty of consistency (sometimes called quasi-estoppel) prevents a taxpayer from benefiting in a later year from an error or omission in an earlier year that cannot be corrected because the time to assess tax for the earlier year has expired. Estate of Letts v. Commissioner, 109 T.C. 290, 296 (1997), affd. without published opinion 212 F.3d 600 (11th Cir. 2000). The duty of consistency may apply if: (1) The taxpayer made a representation of fact or reported an item for tax purposes in one tax year; (2) the Commissioner acquiesced in or relied on that fact for that year; and (3) the taxpayer desires to change the representation previously made in a later tax year after the earlier year has been closed by the statute of limitations. Id. at 297; LeFever v. Commissioner, 103 T. C. 525, 543 (1994), affd. 100 F.3d 778 (10th Cir. 1996).
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> Spouses, as well as their estates, may have sufficient identity of interests so that one may be estopped under the duty of consistency by a prior representation of the other. Estate of Letts v. Commissioner, supra at 298; Cluck v. Commissioner, 105 T.C. 324, 333-336 (1995). Respondent contends that Mr. Posner's estate and decedent's estate have sufficient identity of interests that the duty of consistency is applicable. For purposes of this discussion, we assume, without deciding, that there was privity of interest between Mr. Posner's estate and decedent's estate.
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> On brief, respondent acknowledges that the duty of consistency applies "if the inconsistency is a question of fact or a mixed question of fact and law. It does not apply to mutual mistake on the part of a taxpayer and the Service concerning

> a pure question of law." See LeFever v. Commissioner, 100 F.3d at 788; Herrington v. Commissioner, 854 F.2d 755, 758 (5th Cir. 1988), affg. Glass v. Commissioner, 87 T.C. 1087 (1986); S. Pac. Transp. Co. v. Commissioner, 75 T.C. 497, 560 (1980); Unvert v. Commissioner, 72 T.C. 807, 816 (1979), affd. 656 F.2d 483 (9th Cir. 1981). With little elaboration, respondent contends on brief that the inconsistency in question here is a "mixed question of fact and law", so that the duty of consistency applies. We disagree.
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> In Crosley Corp. v. United States, 229 F.2d 376, 380 (6th Cir. 1956), the Court of Appeals for the Sixth Circuit noted that the duty of consistency "is probably applicable in cases where the factual situation is such as to justify the taxpayer in taking either of two possible positions" but generally does not apply "when the error is one of law arising out of a definite factual situation". In the instant case, the inconsistency arose because of a mutual mistake in deciding how Mr. Posner's will should be construed under Maryland law -- a purely legal issue. See McIntyre v. Byrne, 141 A. 2d 692, 695 (Md. 1958) ("The construction of a will is a matter of law for the court to determine"). Mr. Posner's estate did not misrepresent the property or type of property that Mr. Posner had devised to decedent. Respondent has not alleged any facts to show that the estate has been inconsistent with respect to any factual positions or to suggest that the inconsistency in question arose from anything other than a purely legal error in the context of "a definite factual situation". Crosley Corp. v. United States, supra at 380.

The interpretation of the Will was at issue in prolonged litigation in state court. The executor ultimately lost the argument, which the court found important:

> Moreover, the duty of consistency "does not apply where all pertinent facts are known to both the Commissioner and the taxpayer", especially if "the crucial facts are known to both parties and the erroneous deductions are due to a mutual mistake of law." S. Pac. Transp. Co. v. Commissioner, supra at 560; cf. Interlochen Co. v. Commissioner, 232 F.2d 873 (4th Cir. 1956), affg. 24 T.C. 1000 (1955); Hull v. Commissioner, 87 F.2d 260, 262 (4th Cir. 1937) (stating that "a party either knowing the facts, or in a position to know them, cannot claim the benefit of estoppel"), revg. 33 B.T.A. 178 (1935). In the instant case, respondent had reason to know all the relevant facts. When Mr. Posner's estate filed its estate tax return, it adequately disclosed the relevant facts and documents, attaching a copy of Mr. Posner's will.15 Respondent audited the estate tax return of Mr. Posner's estate and allowed the marital deduction.16 Respondent has not alleged any facts to suggest that this audit was insufficient in any regard other than in the failure to apply the law correctly. Under these circumstances, respondent cannot be viewed as justifiably relying on the legal representation on the estate tax return of Mr. Posner's estate.
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> The executor of Mr. Posner's estate and the executor of decedent's estate, as well as respondent's agents upon audit of Mr. Posner's estate's estate tax return, all acted in accordance with the mutual mistake of law that Mr. Posner's will gave decedent a general power of appointment. Indeed, when he filed the estate tax return of decedent's estate, decedent's executor included the marital trust property in decedent's gross estate and paid the resulting estate tax. He steadfastly maintained in the State court litigation that decedent possessed a testamentary power of appointment over the marital trust property. Only after the court of special appeals rejected this position and the Maryland Court of Appeals declined to hear the appeal did he file the refund claim. Respondent has not

> carried his burden to show that the duty of consistency should apply in these circumstances.

The IRS applied the duty of consistency in TAM 200407018. The facts are interesting; oil paintings passed in a life estate to decedent's spouse for which no QTIP election was made, and other paintings passed into a QTIP trust. A pastel painting was allocated to the QTIP trust. The surviving spouse died and the painting was sold, and determined actually to be an oil painting. The surviving spouse's estate excluded the proceeds of the sale. The IRS disagreed, stating:

> As described above, the doctrine applies where the same taxpayer makes conflicting representations. However, the duty of consistency can also be applied to bind one person to a representation made by another where the two are deemed to be in privity. Whether there is sufficient identity of interests between the parties to warrant the application of the duty of consistency depends on the facts and circumstances of each case. Estate of Letts v. Commissioner, 109 T.C. 290 (1997); Cluck v. Commissioner, 105 T.C. at 333-336 (concluding that a husband and wife can have interests so closely aligned that one spouse may be estopped under the duty of consistency doctrine by the prior representations of the other spouse). See also, Beltzer v. United States, 495 F.2d 211 (8th Cir. 1973) (estate beneficiary was bound by representation of value made by the executor-beneficiary of the estate); Griffith v. United States, 27 AFTR 2d 754 (N.D. Tex. 1971); McMillan v. United States, 14 AFTR 2d 5704 (S.D. W. Va. 1964); Hess v. United States, 537 F.2d 457 (Ct. Cl. 1976); Ford v. United States, 276 F.2d 17 (Ct. Cl. 1960) (estate beneficiaries who were minors at the time the estate was administered were not bound by estate representations as to the value of inherited property).
>
> In Estate of Letts v. Commissioner, cited above, the decedent's husband's will created a marital trust for the benefit of the decedent that was intended to qualify as QTIP property, for purposes of the federal estate tax marital deduction. Decedent's only interests in the trust were a right to receive all trust income, a right to withdraw up to $40,000 per year and a right to receive at the trustee's discretion, distributions of principal for her comfort maintenance and support. In preparing Schedule M of the estate tax return, the executors of husband's estate checked the "no" box, utilized to signify that a QTIP election was not being made. However, the executors claimed a marital deduction for the value of the property passing to the marital trust. Upon the decedent's death, the decedent's estate contended that the marital trust was not includible in the Decedent's gross estate under section 2044, or any other Code section, on the basis that the husband's estate, by checking the "no" box, had not treated the property as QTIP property. Further, other than the power to withdraw $40,000 annually, the decedent had no general power of appointment over the property justifying inclusion under section 2041. The taxpayer further argued that a duty of consistency did not apply between the decedent's estate and the estate of her husband.
>
> However, the Tax Court disagreed and found that there was a sufficient identity of interests between the husband's estate and decedent's estate such that the duty of consistency would apply. Initially, the Tax Court noted that, "[i]t is a basic policy of the marital deduction that property that passes untaxed from a predeceasing spouse to a surviving spouse is included in the gross estate of the

surviving spouse." Estate of Letts v. Commissioner, 109 T.C. at 295. The court then concluded:

> There is a sufficient identity of interests between the Estates of James Letts, Jr., and of decedent to trigger the duty of consistency. Decedent and James Letts, Jr. were married. Their estates were a single economic unit. Decedent's husband left his estate to decedent, James P. Letts III, and Joanne Magbee [husband and decedent's children]. Decedent was an executrix of her husband's estate. James P. Letts III signed both returns. JoAnne Magbee is also a co-executor of, signed the estate tax return for, decedent's estate.

Estate of Letts v. Commissioner, 109 T.C. at 298.

In the instant case, we believe that the duty of consistency does apply to bind the Decedent's estate to the representations made by H's estate regarding the qualification of Painting for the marital deduction. Initially, we note that all three elements required for application of the duty of consistency have been satisfied. For purposes of the duty of consistency, a taxpayer's treatment of an item on a return can be a representation that facts exist which are consistent with how the taxpayer reports the item on the return. Estate of Letts v. Commissioner, 109 T.C. at 299. Several representations were made by H's estate on the estate tax return, regarding the treatment of the Painting for estate tax purposes. An appraisal attached to the federal estate tax return, identified Painting as a "pastel". H's estate represented that Painting passed under Section V of H's will. Further, by identifying the property as passing under Section V and claiming a marital deduction for Painting, the estate represented that Decedent possessed a life estate coupled with a general power of appointment with respect to Painting, that qualified Painting for the marital deduction under section 2056(b)(5). Thus, the first element has been met. Estate of Letts v. Commissioner, 109 T.C. at 300.

Further, the Service relied on the representations that Painting passed under Section V of the will, that Decedent had a general power of appointment with respect to Painting, and therefore that the Painting qualified for the marital deduction. The Service relies on a fact if a taxpayer files a return that contains an inadequately disclosed item of which the Service was not otherwise aware, the Service accepts the return, and the time to assess tax expires without an audit of that return. Estate of Letts v. Commissioner, 109 T.C. at 300. In the instant case, there was nothing on the estate tax return to alert the IRS as to any issue presented regarding the treatment of Painting, nor did H's estate provide any facts to show that Painting should have passed under Section IV and was not subject to the marital deduction. Thus, based on the representations made on the estate tax return, the Service allowed the marital deduction with respect to Painting. The Service may rely on a presumption of correctness of a return that is given to the Service under the penalties of perjury. Hughes & Luce, L.L.P. v. Commissioner, T.C. Memo. 1994-559. Further, the time to make an adjustment and assess tax with respect to H's estate has expired. Thus, the second element of the duty of consistency has been satisfied.

* * *

Although H's estate and Decedent's estate are different taxpayers, there is sufficient privity between H's estate and Decedent's estate such that Decedent's estate is bound by the representations made by H's estate under the duty of consistency doctrine. Specifically, H and Decedent were married. As the court noted in Estate of Letts, the basic policy rationale underlying the allowance of the estate tax marital deduction is that the property for which a deduction is allowed in the estate of the first spouse to die will be included in the gross estate of the second spouse to die. Thus, H's estate derived a specific tax benefit, a marital deduction, presumptively conditioned on consistent treatment of the assets for which a deduction was allowed in Decedent's estate. Accordingly, for transfer tax purposes, the two estates are treated as a single economic unit. Next, as a practical matter, H's estate and Decedent's estate functioned as a single economic unit, pursuant to which H's estate's property was to be available to the spouse during her lifetime and then pass to Son 1 and Son 2 when she died. Son 1 and Son 2 are the remainder beneficiaries of the interests created under Section IV and Section V of H's will, and the marital trust created under the residuary clause of H's will. The Section V property and the residuary marital trust are also included in Decedent's gross estate. Moreover, Decedent was a co-executor of H's estate. As co-executor, Decedent signed the Form 706 declaring, under the penalties of perjury, that she had examined the return, including accompanying schedules and statements, and to the best of her knowledge and belief, the return was true, correct and complete. Thus, as was the case in Estate of Letts, H's estate and Decedent's estate were in privity, both for purposes of disposing of H's property and for transfer tax purposes.

However, Decedent's estate contends that H's estate and Decedent's estate were not in privity, and therefore, the duty of consistency does not apply. In this regard, the estate notes that Decedent had little involvement with the preparation of H's estate's Form 706, and relied on the other co-executors to make all decisions regarding the Form 706, including the decision to characterize Painting as Section V property.

It has been clearly established by several courts that a co-executor's lack of participation does not preclude the application of the duty of consistency. In Beltzer v. United States, the taxpayer, a co-executor of his father's estate, inherited stock that had been reported on the estate tax return as having a fair market value of $59,713. After the statute of limitations on assessments against the estate expired, the taxpayer sold his shares for $140,000. For purposes of determining gain on the sale of the stock, the taxpayer asserted that the stock had a fair market value of $118,020 on the date of his father's death, despite the fact that he had signed the estate tax return and had received the benefit of the lower reported estate tax value. The taxpayer argued that he should not be bound by the estate's representation of value, because he relied on his co-executor to prepare the estate tax return. The court rejected this argument stating: "A taxpayer, in this situation, innocent or otherwise, who has already had the advantages of a past alleged misstatement -- such advantage now beyond recoupment -- may not change his posture, and by claiming he should have properly paid more tax before, avoid the present levy." Beltzer v. United States, 495 F.2d at 212-13. See also, Estate of Letts v. Commissioner, 109 T.C. at 298-299; McMillan v. United States, 14 AFTR 2d at 5704.

In Conrad Janis, et ux. et al. v. Commissioner, T.C. Memo. 2004-117, the issue was whether the taxpayer could calculate a gallery's cost of goods sold using the undiscounted value of the gallery's collection of artwork rather than the discounted value used for federal estate tax purposes. The court applied the duty of consistency:

> Respondent has established that all three elements of the duty of consistency are present in this case. Conrad and Carroll agreed that the discounted value of the collection was $14,500,000, and the Commissioner relied upon that value in assessing the estate tax owed by Sidney's estate. Once the period for assessment against Sidney's estate had closed, however, petitioners claimed that the collection's undiscounted value should be used to calculate the gallery's COGS. Because all three elements of the duty of consistency are satisfied, we hold that petitioners are bound to use the collection's discounted value as their basis for purposes of calculating the gallery's COGS for 1990 through 1997.

T. MISCELLANEOUS

1. **Application of Florida Stamp Tax to Transfers Between Grantor and Wholly-Owned Grantee**. In Crescent Miami Center, LLC v. Florida Department of Revenue, ___ So. 2d ___, 2005 WL 1176053, (Fl. S.Ct. 2005), the Court determined that a transfer of property between a grantor and its wholly-owned grantee, absent exchange of value, is without consideration and not subject to the stamp tax imposed by section 201.02(1) of the Florida Statutes. Here, Crescent Real Estate Equities, LP was the sole owner of CRE Management IX, LLC, which was in turn the sole general partner of Crescent Real Estate Funding IX, LP. Crescent Real Estate Equities, LP was also the sole limited partner of Crescent Real Estate Funding IX, LP. Crescent Real Estate Equities, LP formed Crescent Miami Center, LLC, with 99.9% owned by Crescent Real Estate Funding IX, LP and 0.1% owned by CRE Management IX, LLC. Crescent Real Estate Equities, LP then transferred a parcel of real property to Crescent Miami Center, LLC. If, on the other hand, a transfer is not among sole owners - - for instance, real estate transferred by two of three partners to a partnership - - the tax would apply. See Muben-Lamar, L.P. v. Department of Revenue, 763 So.2d 1209 (Fla. 1st DCA 2000), review granted but subsequently dismissed, 789 So. 2d 337 (Fla. 2001).

2. **ERISA Pre-Empts State Slayer Statute**. Most states have a statute which limit the ability of a person who murders another from receiving benefits on account of the murder - -e.g. intestate shares, joint account proceeds, life insurance proceeds. In Ahmed v. Ahmed, Slip Cop, 2005 WL 858176 (Ohio Ct. App. 2004), the Ohio Court of Appeals held that ERISA preempted the Ohio statute with respect to group term insurance provided under a plan covered by ERISA.

3. **Lawyer Retained by Testator to Disinherit Beneficiary Whom Lawyer Represents on Unrelated Matters**. ABA Formal Opinion 05-434 states that there is normally no conflict of interest when a lawyer is engaged by a testator to disinherit a beneficiary whom the lawyer represents on unrelated matters, unless doing so would violate a legal obligation of the testator to the beneficiary or unless there is a significant risk that the lawyer's representation of the testator will be materially limited by the lawyer's responsibilities to the beneficiary. The opinion states:

> The preparation of an instrument disinheriting a beneficiary ordinarily is a simple, straightforward, almost ministerial task, without call for the lawyer to consider alternative courses of action, and it is difficult to imagine a circumstance in which a responsibility of the lawyer to her other client (even a

client who is a presumptive beneficiary of the testator's bounty) would pose a significant risk of limiting the lawyer's ability to discharge her professional obligations to the testator. The lawyer's representation of a testator does not, of itself, create responsibilities owed by the lawyer to prospective beneficiaries (even one who is the lawyer's client as to an unrelated matter), other than the duty to effect the testator's intent as expressed explicitly or implicitly in the instrument. If, however, because of her relationship with the other client, the lawyer finds it repugnant or distasteful to carry out the assignment, or has good faith doubts as to whether there is a significant risk that she will be able to exercise independent professional judgment on behalf of the testator, then the lawyer may decline the engagement.

4. **Statute of Limitations Inapplicable to Trustee's Refund Claim**. Wachovia Bank erroneously filed income tax returns in 1997 and 1998 for a charitable remainder trust. Wachovia sought a refund more than three years after the returns were filed and the IRS denied the claim citing section 6511 (a). A U. S. District Court disagreed with the IRS holding that the clear language of section 6511 (a) states that claims for refunds "in respect of which tax the taxpayer is required to file a return shall be filed by the taxpayer within 3 years from the time the return was filed or two years from the time the tax was paid" whichever is later. Wachovia Bank, N.A. v. United States, 95 A.F.T.R. 2d 2005-1939 (M.D. Fla. 2005). The Court held that because Wachovia was not required to file a return section 6511 does not apply.

5. **Publication 559: Survivors, Executors, and Administrators for Use in Preparing 2004 Returns**. The publication is designed to help those in charge of estates complete and file federal income tax returns.

6. **Bankruptcy of an LLC Member**. In Movitz v. Fiesta, 319 B. R. 200 (2005), the Bankruptcy Court held that if a member of an LLC, other than the manager, files a Chapter 7 petition, the bankruptcy trustee acquires all of the member's rights and interests, rather than is only a judgment creditor, unless the operating agreement of an LLC imposes obligations on its members and is, therefore, an executory contract. In order to be an executory contract the operating agreement must impose obligations on the members which is "so material that if the member did not perform it, Fiesta would owe no further obligations to that member."

The LLC had been created for estate planning purposes: to remove assets from parents' estates and to accumulate assets for the benefit of children. The court found no obligation assumed by the members in that plan nor any as part of the operating agreement itself. Indeed the closest the court came to finding an obligation on the part of a member was an obligation not to withdraw but because the member would receive $1.00 if he or she did withdraw the court characterized refraining from withdrawal as an option rather than an obligation. Where partners or members had capital requirements or were obligated to participate in management it is likely that an agreement would be executory.

The bankruptcy trustee was in court complaining about loans to other members, redemptions of other members' interests. The court held that the trustee could pursue any action which a member could pursue.

A similar issue was addressed by Vice-Chancellor Strine of the Delaware Chancery Court in Milford Power Company, LLC v. PDC Milford Power, LLC, 866 A.2d 738 (Del. Super. Ct. 2004). There the parties agreed that the LLC agreement was an executory contract because the member in question (PDC) had an important managerial role in the LLC. The LLC agreement provided that upon a member's filing for bankruptcy the member will automatically be deemed to have withdrawn from the agreement and assigned its interest to the remaining members (referred to as an Ipso Facto clause). The opinion extensively reviews case-law and commentator opinion with respect to Ipso Facto clauses and reaches an idiosyncratic result, declining to hold that the Bankruptcy Code entirely preempts Ipso Facto clauses nor to hold that there is no preemption at all. Instead, the court allowed the member to remain in the LLC for economic purposes but not governance purposes. The case may be profitably read for its discussion of the issue.

7. Medicaid Support Trusts. To ensure that a trust is not considered an available resource to the creditors of a beneficiary, particularly, Medicaid, the safest path continues to be for the trust to be purely discretionary, ideally with other beneficiaries as well. In In re Barkema Trust, 690 N. W. 2d 50 (Iowa, 2004), the court included the assets of a trust for the support of a beneficiary in the beneficiary's estate for purposes of a Medicaid claim. In Estate of DeMartine v. Division of Medical Assistance and Health Services, 861 A. 2d 138 (N.J. 2004), the decedent's wife died six months before he did leaving a trust, still unfunded at his death, which would pay the income to the decedent for his lifetime and principal for his "nonsupport needs." The court concluded this was an arrangement for the conveyance of the assets of a Medicaid beneficiary and thus were properly part of the decedent's estate for Medicaid claim purposes. For comparison see Corcoran v. Department of Social Services, 859 A.2d 533 (Conn. 2004) (distributions subject to an ascertainable standard created a support trust) and Zeoli v. Commissioner of Social Services, 425 A.2d 553 (Conn. 1979) (distributions in trustee's discretion with precatory guidance as to intent did not create a support trust).

8. Tax Apportionment. In Seegel v. Miller, 820 N.E. 2d 809 (Mass. 2005) the decedent's Will and Revocable Trust provided for estate taxes to be paid from residue in a normal marital deduction, exemption equivalent situation. However, subsequent to executing his estate plan, Mr. Miller made numerous large inter vivos gifts which substantially depleted his exemption equivalent. The estate asked that the court reform Mr. Miller's Will and Trust to provide for estate tax apportionment among the transfers which caused the estate tax, so as to protect the marital trust from bearing any share of the tax (and thus creating "tax on tax"). The court agreed.

In Estate of Smith v. Smith, 891 So. 2d 811 (Miss. 2005), Mr. Smith died without a Will but with three life insurance policies: a $2,000,000 policy payable to his father; a $125,000 policy payable to his former wife; and a $30,000 policy payable to his current wife. The total estate was about $9,400,000 of which only the insurance created any estate tax liability. At issue was whether the tax was apportioned on the amount of the taxable estate or gross estate. The trial court had apportioned the tax based on the gross estate with the result that the recipient of the non-insurance assets paid substantial tax. The Mississippi Supreme Court reversed and held that apportionment was based on the taxable estate, because the Mississippi apportionment statute directs that if there is a federal apportionment it will be the state rule. Thus section 2206 of the Code controls.

The Alabama apportionment statute is pay taxes from residue. In Hollis v. Forrester, ___ So. 2d ___, 2004 WL 2415923 (Ala. Civ. App. 2004), *aff'd by* Exparte Forrester, ___ So. 2d. ___, 2005 WL 797405 (Ala. 2005), at husband's death a QTIP trust was created (called the "Non-Exempt Marital Trust"). Wife's Will did not contain any direction about the payment of estate taxes. Section 2207A apportioned the federal estate taxes due on account of the trust to the trust but the Alabama apportionment statute apportioned Alabama estate taxes to the residue.

9. Recovery for Premature QPRT Termination is Allowed in Wrongful Death Action. A New York trial court has allowed recovery in a wrongful death case for the early termination of a Qualified Personal Residence Trust. Del Broccolo v. Torres, 780 N.Y.S.2d 857 (Sup. 2004). The grantor of a QPRT was killed in a car accident eight months before the QPRT term ended, thus losing the tax advantages of the QPRT. The court allowed the future tax benefit to be considered in awarding damages holding that the law with respect to the QPRT was not speculative or subject to change on these facts.

10. Application of Bankruptcy Act to Domestic Asset Protection Trusts. The Bankruptcy Abuse Protection and Consumer Protection Act of 2005 adds a new "clawback" provision which affects transfers to domestic asset protection trusts. The Bankruptcy Trustee may include as part of the debtor's estate transfers made by a debtor to a self-settled trust within 10 years of the bankruptcy filing if the transfer was made with the actual intent to hinder, delay or defraud present or future creditors. The provision also includes transfers to any "similar device" within the clawback provision. For instance, will a transfer to a qualified plan, which would be exempt otherwise from claims in bankruptcy, within 10 years be subject to the provision? An amendment to the Act which would have clarified that such was not the case was defeated.

The requirement that "actual intent" be proven may be helpful if bona fide reasons other than asset protection can be shown for the creation of a trust in a jurisdiction which exempts self-settled trusts from the claims of creditors. Income tax planning and long-term or perpetual trust periods would seem to be potential such reasons. Suppose a trust is created for the benefit of transferor's spouse and children without standards. Transferor retains a testamentary special power of appointment so that there is no completed gift to the trust when it is funded. Suppose further than the transferor's spouse is also given a testamentary special power of appointment and exercises that power by Will to appoint the trust assets to a trust for the transferor's benefit. What is the effect of such a trust upon the transferor's bankruptcy if the transferor's spouse is still alive?

Transfers to charity are protected if they do not exceed 15% of the debtor's gross annual income (or, if they do, if such transfers were consistent with the prior practices of the debtor in making charitable contributions). Transfers to section 529 plans and education IRAs are protected to some extent but not entirely.

The best way to ensure that an asset is not subject to the claims of a person's creditors remains for the person never to have had an interest in the asset. Trusts created by parents for children, for instance.

2004-2005 NOTABLE DEVELOPMENTS OF INTEREST TO ESTATE PLANNERS

-SUPPLEMENTAL MATERIAL-

ALI-ABA Telephone Seminar - Latest IRS Guidance on Circular 230 Standards, June 1, 2005 by Louis A. Mezzullo (Used With Permission)

SECTION A

ALI-ABA Telephone Seminar

Latest IRS Guidance on Circular 230 Standards
June 1, 2005

CIRCULAR 230: ESTATE PLANNING ISSUES

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TABLE OF CONTENTS

Page

CIRCULAR 230: ESTATE PLANNING ISSUES

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I. Introduction

A. On December 20, 2004, the Internal Revenue Service ("IRS") and the Treasury published final amendments to Circular 230 dealing with tax shelter opinions (now referred to as "covered opinions"), required procedures that must be followed by firms that issue such opinions to ensure compliance with the new rules, and so-called "best practices" that tax professionals should follow to preserve public confidence in the tax system. In addition, the IRS issued a proposed amendment to Circular 230 dealing with state and local bond opinions.

B. In response to numerous comments from a number of professional organizations, the IRS and Treasury issued modifications to the final regulations of May 18, 2005, adding a definition of a principal purpose transaction, liberalizing the disclosure requirements, and adding three kinds of written advice to the kinds of advice that are not subject to the covered opinion requirements: post return advice, advice given to an employer by an employee, and so-called negative advice.

C. Circular 230, found in 31 CFR part 10, was initially issued in 1921. It contains rules governing the recognition of attorneys, certified public accountants, enrolled agents, and other persons representing taxpayers before the IRS (practitioners) and prescribes the duties and restrictions relating to practice before the IRS and sanctions for violating the regulations, as well as providing rules applicable to disciplinary proceedings.

D. The IRS and the Treasury had published proposed regulations dealing with most of the issues covered in the final amendments on December 30, 2003. Notably, the proposed amendments referred to "tax shelter opinions," while the final amendments refer to "covered opinions." This subtle change in terminology is accompanied with what many perceive as a broadening of the kinds of opinions subject to detailed requirements.

1. It is arguable that the final regulations do not significantly expand the scope of the types of opinion that must satisfy the covered opinion requirements.

2. Under the proposed regulations, a practitioner providing a more likely than not tax shelter opinion or a marketed tax shelter opinion had to

comply with requirements similar to those contained in the final regulations for covered opinions.

a. A tax shelter opinion was defined as written advice by a practitioner concerning the federal tax aspects of any federal tax issue relating to a tax shelter item or items.

b. A tax shelter item was defined as an item of income, gain, loss, deduction, or credit, the existence or absence of a taxable transfer of property, or the value of property.

c. A tax shelter was defined as any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, a significant purpose of which was the avoidance or evasion of any tax imposed by the Internal Revenue Code.

3. As will be discussed below, under the final regulations, a reliance opinion or a marketed opinion would have been treated as a tax shelter opinion under the proposed regulations and, therefore, would have been subject to the requirements for a tax shelter opinion.

4. Perhaps the significant change under the final regulations is the addition of the requirements dealing with "other written advice."

E. In addition to sanctions, suspension, and disbarment, the American Jobs Creation Act of 2004 authorizes the Treasury and IRS to impose penalties against practitioners who violate any provision of Circular 230 and authorizes injunctions to prevent violations of Circular 230.

F. A practitioner may be censured, suspended or disbarred from practice before the IRS for willfully violating Circular 230 (except the best practices provisions) or recklessly or through gross incompetence violating the covered opinion requirements, the other writing requirements or the compliance provisions.

II. Covered Opinions

A. Introduction.

1. A practitioner rendering a covered opinion must satisfy specific requirements to avoid being sanctioned, suspended or disbarred from practice before the IRS.

a. Formerly referred to as a tax shelter opinion, a covered opinion is written advice, including electronic communications, by a practitioner concerning one or more federal tax issues.

b. For this purpose, a practitioner includes an attorney, an accountant, and an enrolled agent.

B. Definition of a Covered Opinion.

1. Only written advice, including an email and, perhaps, a cell phone text message, on the following is treated as a covered opinion:

   a. A transaction that is the same as or substantially similar to a transaction that, at the time the advice is rendered, the IRS has determined to be a listed tax avoidance transaction and identified by published guidance as a listed transaction under Treas. Reg. § 1.6011-4(b)(2) (referred to hereinafter as a "listed transaction opinion");

   b. Any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, the principal purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code (referred to hereinafter a "tax avoidance transaction" and written advice concerning the transaction is referred to hereinafter as a "tax avoidance opinion"); and

   c. Any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, a significant purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code, if the written advice is:

      (1) A reliance opinion;

      (2) A marketed opinion;

      (3) Subject to conditions of confidentiality; or

      (4) Subject to contractual protection.

2. Excluded Advice. A covered opinion does not include:

   a. Preliminary advice, which is written advice provided to a client during the course of an engagement if a practitioner is reasonably expected to provide subsequent written advice to the client that will satisfy the requirements of § 10.35.

   b. Written advice that is not a listed transaction opinion or a tax avoidance opinion if it:

      (1) Concerns a qualified plan;

      (2) Is a state or local bond opinion; or

(3) Is included in documents required to be filed with the Securities and Exchange Commission.

(a) It is unclear whether written advice contained in documents referred to or summarized in such filings is included in this exception.

c. Written advice prepared for and provided to a taxpayer, solely for use by that taxpayer, after the taxpayer has filed a tax return with the IRS reflecting the tax benefits of the transaction (a post return opinion).

(1) This exclusion does not apply if the practitioner knows or has reason to know that the written advice will be relied upon by the taxpayer to take a position on a tax return (including for these purposes an amended return that claims tax benefits on a previously filed return) filed after the date on which the advice is provided to the taxpayer.

d. Written advice provided to an employer by a practitioner in that practitioner's capacity as an employee of that employer solely for purposes of determining the tax liability of the employer.

(1) Hopefully, this exclusion will be expanded to cover employees of related entities and other relationships, such as a partner in a partnership, a member of a limited liability company, and fiduciaries and beneficiaries in the case of trusts and estates.

e. Written advice that does not resolve a federal tax issue in the taxpayer's favor, unless the advice reaches a conclusion favorable to the taxpayer at any confidence level (e.g., not frivolous, realistic possibility of success, reasonable basis or substantial authority) with respect to that issue (a negative opinion).

(1) If the written advice concerns more than one federal tax issue, the advice must satisfy the covered opinion requirements with respect to any other federal tax issue that does not fall under this exclusion.

3. Principal Purpose.

a. The modifications provided the following definition of principal purpose:

For purposes of [§ 10.35] the principal purpose of a partnership or other entity, investment plan or arrangement, or other plan or arrangement is the avoidance or evasion of any tax imposed by the

Internal Revenue Code if that purpose exceeds any other purpose. The principal purpose of a partnership or other entity, investment plan or arrangement, or other plan or arrangement is not to avoid or evade federal tax if that partnership, entity, plan or arrangement has as its purpose the claiming of tax benefits in a manner consistent with the statute and Congressional purpose. A partnership, entity, plan or arrangement may have a significant purpose of avoidance or evasion even though it does not the have the principal purpose of avoidance or evasion [as defined for purposes of § 10.35].

b. Despite the addition of a definition of principal purpose, in many cases it will be difficult to determine whether a transaction has as its principal purpose tax avoidance, and the conservative practitioner may decide to err on the side of caution by treating any transaction that involves significant tax savings as a tax avoidance transaction.

(1) This will be a heavy price to pay if the transaction turns out not to have been a tax avoidance transaction.

4. Whether written advice constitutes a covered opinion is significant for two reasons:

a. The detailed covered opinion requirements set forth below must be satisfied; and

b. The compliance procedures discussed below only refer to covered opinions.

C. Reliance Opinion.

1. Written advice is a reliance opinion if the advice concludes at a confidence level of more likely than not (a greater than 50% likelihood) that one or more significant federal tax issues would be resolved in the taxpayer's favor.

a. A federal tax issue is a question concerning the federal tax treatment of an item of income, gain, loss, deduction, or credit; the existence or absence of a taxable transfer of property; or the value of property.

b. An issue is only significant if the IRS has a reasonable basis for a successful challenge and the resolution of the challenge could have a significant impact, whether beneficial or adverse and under any reasonably foreseeable circumstances, on the overall federal tax treatment of the transactions or matters addressed in the opinion.

c. Consequently, written advice dealing with federal tax issues that are not significant will not be treated as covered opinions, unless they are listed transaction opinions, tax avoidance opinions, marketed opinions, or opinions subject to conditions of confidentiality or contractual protection.

2. An opinion, other than a listed transaction opinion or tax avoidance opinion, will not be treated as a reliance opinion if the practitioner prominently discloses that the advice was not intended to be used and cannot be used by the taxpayer to avoid penalties that may be imposed on the taxpayer.

3. Prominently disclosed. An item is prominently disclosed if it is readily apparent to a reader of the written advice.

a. Whether an item is readily apparent will depend on the facts and circumstances surrounding the written advice, including, but not limited to, the sophistication of the taxpayer and the length of the written advice.

b. At a minimum, to be prominently displayed an item must be set forth in a separate section (and not in a footnote) in a typeface that is the same size or larger than the typeface in any discussion of the facts or law in the written advice.

D. Other Types of Advice Treated as Covered Opinions.

1. A marketed opinion is advice that will be used by someone other than the practitioner, or a member or employee of the practitioner's firm, in promoting, marketing, or recommending the transaction to one or more taxpayers unless the advice prominently discloses that it was not intended to be used and cannot be used to avoid penalties and was written to support the promotion or marketing of the transaction and that the taxpayer should seek independent tax advice.

a. Hopefully, a marketed opinion will not include a situation where the practitioner is providing advice to an entity and the entity forwards the tax advice to its owners.

b. See the suggestion below for clarification about what constitutes a marketed opinion.

2. Written advice is subject to conditions of confidentiality if the practitioner imposes on one or more recipients of the advice a limitation on disclosure to protect the confidentiality of the practitioner's tax strategies, but not if the practitioner simply claims that the transaction is proprietary or exclusive.

a. Hopefully, advice will not be treated as subject to confidentiality conditions simply because it contains a statement that the recipient is not to disclose the opinion to a third party, when the purpose of the restriction is to prevent the recipient from disclosing the opinion itself, not the strategy.

3. Written advice is subject to contractual protection if the taxpayer has the right to a full or partial refund of fees paid to the practitioner if all or a part of the intended tax consequences are not sustained or the fees paid are contingent on the taxpayer's realization of tax benefits.

E. Requirements for Covered Opinions. A practitioner providing a covered opinion must comply with each of the following requirements.

1. Factual matters.

a. The practitioner must use reasonable efforts to identify and ascertain the facts, which may relate to future events if a transaction is prospective or proposed, and to determine which facts are relevant.

(1) The opinion must identify and consider all facts that the practitioner determines to be relevant.

b. The practitioner must not base the opinion on any unreasonable factual assumptions (including assumptions as to future events).

(1) An unreasonable factual assumption includes a factual assumption that the practitioner knows or should know is incorrect or incomplete.

(a) For example, it is unreasonable to assume that a transaction has a business purpose or that a transaction is potentially profitable apart from tax benefits.

(2) A factual assumption includes reliance on a projection, financial forecast or appraisal.

(a) It is unreasonable for a practitioner to rely on a projection, financial forecast or appraisal if the practitioner knows or should know that the projection, financial forecast or appraisal is incorrect or incomplete or was prepared by a person lacking the skills or qualifications necessary to prepare such projection, financial forecast or appraisal.

(3) The opinion must identify in a separate section all factual assumptions relied upon by the practitioner.

c. The practitioner must not base the opinion on any unreasonable factual representations, statements or findings of the taxpayer or any other person.

(1) An unreasonable factual representation includes a factual representation that the practitioner knows or should know is incorrect or incomplete.

(a) For example, a practitioner may not rely on a factual representation that a transaction has a business purpose if the representation does not include a specific description of the business purpose or the practitioner knows or should know that the representation is incorrect or incomplete.

(2) The opinion must identify in a separate section all factual representations, statements or findings of the taxpayer relied upon by the practitioner.

2. Relate law to facts.

a. The opinion must relate the applicable law (including potentially applicable judicial doctrines) to the relevant facts.

b. The practitioner must not assume the favorable resolution of any significant federal tax issue except in the case of a limited scope opinion or if the practitioner relied on the opinion of another practitioner.

c. The opinion must not contain internally inconsistent legal analyses or conclusions.

3. Evaluation of significant federal tax issues.

a. In general. The opinion must consider all significant federal tax issues except in the case of a limited scope opinion or if the practitioner relied on the opinion of another practitioner.

b. Conclusion as to each significant federal tax issue.

(1) The opinion must provide the practitioner's conclusion as to the likelihood that the taxpayer will prevail on the merits with respect to each significant federal tax issue considered in the opinion.

(2) If the practitioner is unable to reach a conclusion with respect to one or more of those issues, the opinion must state that the practitioner is unable to reach a conclusion with respect to those issues.

(3) The opinion must describe the reasons for the conclusions, including the facts and analysis supporting the conclusions, or describe the reasons that the practitioner is unable to reach a conclusion as to one or more issues.

(4) If the practitioner fails to reach a conclusion at a confidence level of at least more likely than not with respect to one or more significant federal tax issues considered, the opinion must include the appropriate disclosures required.

c. Evaluation based on chances of success on the merits. In evaluating the significant federal tax issues addressed in the opinion, the practitioner must not take into account the possibility that:

(1) A tax return will not be audited;

(2) An issue will not be raised on audit; or

(3) An issue will be resolved through settlement if raised.

d. Marketed opinions.

(1) In the case of a marketed opinion, the opinion must provide the practitioner's conclusion that the taxpayer will prevail on the merits at a confidence level of at least more likely than not with respect to each significant federal tax issue.

(2) If the practitioner is unable to reach a more likely than not conclusion with respect to each significant federal tax issue, the practitioner must not provide the marketed opinion, but may provide written advice if it contains the appropriate disclosure.

e. Limited scope opinions.

(1) The practitioner may provide an opinion that considers less than all of the significant federal tax issues if:

(a) The practitioner and the taxpayer agree that the scope of the opinion and the taxpayer's potential reliance on the opinion for purposes of avoiding penalties that may be imposed on the taxpayer are limited to the federal tax issues addressed in the opinion;

(b) The opinion is not a listed transaction opinion, a tax avoidance opinion, or a marketed opinion; and

(c) The opinion includes the appropriate disclosure.

(2) A practitioner may make reasonable assumptions regarding the favorable resolution of a federal tax issue (an assumed issue) for purposes of providing an opinion on less than all of the significant federal tax issues in a limited scope opinion.

(a) The opinion must identify in a separate section all issues for which the practitioner assumed a favorable resolution.

4. Overall conclusion.

a. The opinion must provide the practitioner's overall conclusion as to the likelihood that the federal tax treatment of the transaction or matter that is the subject of the opinion is the proper treatment and the reasons for that conclusion.

b. If the practitioner is unable to reach an overall conclusion, the opinion must state that the practitioner is unable to reach an overall conclusion and describe the reasons for the practitioner's inability to reach a conclusion.

c. In the case of a marketed opinion, the opinion must provide the practitioner's overall conclusion that the federal tax treatment of the transaction or matter that is the subject of the opinion is the proper treatment at a confidence level of at least more likely than not.

5. Competence to provide opinion; reliance on opinions of others.

a. The practitioner must be knowledgeable in all of the aspects of federal tax law relevant to the opinion being rendered, except that the practitioner may rely on the opinion of another practitioner with respect to one or more significant federal tax issues, unless the practitioner knows or should know that the opinion of the other practitioner should not be relied on.

b. If a practitioner relies on the opinion of another practitioner, the relying practitioner's opinion must identify the other opinion and set forth the conclusions reached in the other opinion.

c. The practitioner must be satisfied that the combined analysis of the opinions, taken as a whole, and the overall conclusion, if any, satisfy the requirements of this section.

6. Required disclosures. A covered opinion must contain all of the following disclosures that apply:

a. Relationship between promoter and practitioner. An opinion must prominently disclose the existence of:

(1) Any compensation arrangement, such as a referral fee or a fee-sharing arrangement, between the practitioner (or the practitioner's firm or any person who is a member of, associated with, or employed by the practitioner's firm) and any person (other than the client for whom the opinion is prepared) with respect to promoting, marketing or recommending the entity, plan, or arrangement (or a substantially similar arrangement) that is the subject of the opinion; or

(2) Any referral agreement between the practitioner (or the practitioner's firm or any person who is a member of, associated with, or employed by the practitioner's firm) and a person (other than the client for whom the opinion is prepared) engaged in promoting, marketing or recommending the entity, plan, or arrangement (or a substantially similar arrangement) that is the subject of the opinion.

b. Marketed opinions. A marketed opinion must prominently disclose that:

(1) The opinion was written to support the promotion or marketing of the transactions or matters addressed in the opinion; and

(2) The taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

c. Limited scope opinions. A limited scope opinion must prominently disclose that:

(1) The opinion is limited to the one or more federal tax issues addressed in the opinion;

(2) Additional issues may exist that could affect the federal tax treatment of the transaction or matter that is the subject of

the opinion and the opinion does not consider or provide a conclusion with respect to any additional issues; and

(3) With respect to any significant federal tax issues outside the limited scope of the opinion, the opinion was not written, and cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer.

d. Opinions that fail to reach a more likely than not conclusion. An opinion that does not reach a conclusion at a confidence level of at least more likely than not with respect to a significant federal tax issue must prominently disclose that:

(1) The opinion does not reach a conclusion at a confidence level of at least more likely than not with respect to one or more significant federal tax issues addressed by the opinion; and

(2) With respect to those significant federal tax issues, the opinion was not written, and cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer.

e. Advice regarding required disclosures. In the case of any disclosure required under this section, the practitioner may not provide advice to any person that is contrary to or inconsistent with the required disclosure.

(1) In this case, advice presumably includes oral advice.

7. Effect of opinion that meets these standards. An opinion that meets these requirements satisfies the practitioner's responsibilities under Circular 230, but the persuasiveness of the opinion with regard to the tax issues in question and the taxpayer's good faith reliance on the opinion will be determined separately under applicable provisions of the law and regulations.

III. Other Written Advice and Compliance

A. A practitioner who provides written advice that is not a covered opinion is subject to the following requirements:

1. A practitioner must not give written advice (including electronic communications) concerning one or more federal tax issues if the practitioner bases the written advice on unreasonable factual or legal assumptions (including assumptions as to future events), unreasonably relies upon representations, statements, findings or agreements of the taxpayer or any other person, does not consider all relevant facts that the

practitioner knows or should know, or, in evaluating a federal tax issue, takes into account the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be resolved through settlement if raised.

2. All facts and circumstances, including the scope of the engagement and the type and specificity of the advice sought by the client will be considered in determining whether a practitioner has failed to comply with this section.

3. In the case of an opinion the practitioner knows or has reason to know will be used or referred to by a person other than the practitioner (or a person who is a member of, associated with, or employed by the practitioner's firm) in promoting, marketing or recommending to one or more taxpayers a partnership or other entity, investment plan or arrangement a significant purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code, the determination of whether a practitioner has failed to comply with this requirement will be made on the basis of a heightened standard of care because of the greater risk caused by the practitioner's lack of knowledge of the taxpayer's particular circumstances.

    a. This should be an indication that the final amendments contemplate written advice may be relied on by others without it being treated as a marketed opinion (and therefore a covered opinion), where, for example, an employer provides tax information prepared by a practitioner to its employees with regard to the tax treatment of certain employee benefits.

B. <u>Compliance</u>.

1. The amendments retain the procedures in the proposed regulations designed to ensure compliance.

2. Any practitioner who has or shares principal authority or responsibility for overseeing a firm's practice of providing advice concerning federal tax issues must take reasonable steps to ensure that the firm has adequate procedures in effect for all members, associates, and employees for purposes of complying with the requirements for covered opinions.

3. A practitioner will be subject to discipline for failing to comply with these requirements if:

    a. The practitioner through willfulness, recklessness or gross incompetence does not take reasonable steps to ensure that the firm has adequate procedures to comply with the requirements for covered opinions, and one or more individuals who are members of, associated with, or employed by, the firm are, or have, engaged in a pattern or practice, in connection with their practice with the firm, of failing to comply with those requirements; or

b. The practitioner knows or should know that one or more individuals who are members of, associated with, or employed by, the firm are, or have, engaged in a pattern or practice, in connection with their practice with the firm, that does not comply with the requirements for covered opinions and the practitioner, through willfulness, recklessness or gross incompetence, fails to take prompt action to correct the non-compliance.

IV. Best Practices

A. <u>Best Practices for Tax Advisors</u>.

1. Tax advisors (a broader term than practitioners) should provide clients with the highest quality of representation concerning federal tax issues by adhering to best practices in providing advice and in preparing or assisting in the preparation of a submission to the IRS.

2. In addition to compliance with the standards of practice provided elsewhere in the final amendments, best practices include the following:

a. Communicating clearly with the client regarding the terms of the engagement.

(1) For example, the advisor should determine the client's expected purpose for and use of the advice and should have a clear understanding with the client regarding the form and scope of advice or assistance to be rendered.

b. Establishing the facts, determining which facts are relevant, evaluating the reasonableness of any assumptions or representations, relating the applicable law (including potentially applicable judicial doctrines) to the relevant facts and arriving at a conclusion supported by the law and the facts.

c. Advising the client regarding the import of the conclusions reached, including, for example, whether a taxpayer may avoid accuracy-related penalties under the Internal Revenue Code if a taxpayer acts in reliance on the advice.

d. Acting fairly and with integrity in practice before the IRS.

B. <u>Procedures to Ensure Best Practices for Tax Advisors</u>.

1. Tax advisors with responsibility for overseeing a firm's practice of providing advice concerning federal tax issues or preparing or assisting in

the preparation of submissions to the IRS should take reasonable steps to ensure that the firm's procedures for all members, associates, and employees are consistent with the best practices set forth above.

V. Effective Dates and Creation of Advisory Committees

A. Effective Dates.

1. The effective date for the amendments to Circular 230 is 180 days after the publication of the amendments in the Federal Register (June 20, 2005), except for the creation of advisory committees, which is effective as of the date of publication (December 20, 2004).

B. Advisory Committees.

1. To promote and maintain the public's confidence in tax advisors, the Director of the Office of Professional Responsibility is authorized to establish one or more advisory committees composed of at least five individuals authorized to practice before the IRS.

2. The Director should ensure that membership of an advisory committee is balanced among those who practice as attorneys, accountants, and enrolled agents.

3. Under procedures prescribed by the Director, an advisory committee may review and make general recommendations regarding professional standards or best practices for tax advisors, including whether hypothetical conduct would give rise to a violation of the requirements for covered opinions and the compliance provisions.

VI. Need for Additional Clarification

A. In General.

1. The amendments to Circular 230 dealing with covered opinions and other written tax advice, as well as compliance procedures and best practices, are unnecessary with regard to the practices of the vast majority of practitioners to achieve the purposes expressed in the preamble to the final amendments.

2. However, all responsible tax professionals would agree that, because of the abuses of a small minority, rules regarding certain types of tax advice have become necessary to preserve the integrity of the system.

3. Nevertheless, it is equally important that the new rules do not stifle needed tax advice required by taxpayers on a daily basis with regard to a myriad of issues, particularly when such advice is not meant to protect the taxpayer from any penalties.

a. For example, an overly-broad reading of the definition of a tax avoidance opinion, requiring written tax advice to satisfy the covered opinion requirements and precluding any ability to opt out with appropriate disclosure, would considerably increase the cost of providing every-day written tax advice.

b. In addition, a restrictive definition of preliminary advice, requiring for many types of every-day written tax advice either a comprehensive discussion of all significant federal tax issues or a disclosure, would also add considerable cost or, in the case of the disclosure, confusion on the part of the recipient of the advice.

c. Finally, an overly-broad definition of a tax avoidance opinion coupled with a restrictive definition of preliminary tax advice would encourage practitioners to return to giving oral advice rather than using emails, a result that would be inefficient and, because the recipient would not have the advice in writing, could lead to misinterpretation of the advice.

4. It is with these goals in mind that the following additional clarifications to the rules should be made in some form that practitioners and the government can both rely on.

B. Covered Opinions.

1. A tax avoidance transaction (the primary purpose of the transaction is tax avoidance) should be limited to a transaction in which the intended result of the transaction is the reduction in the tax liability of one or more taxpayers without any substantial change in the economic circumstances of the taxpayer or taxpayers other than the reduction in tax liability. Tax liability includes liability for income, gift, estate, and generation skipping taxes. Economic circumstances include changes to the net worth of the taxpayer before and after the transaction, disregarding any reduction in tax liability as a result of the transaction, and transfers of assets between or among family members and trusts or business entities owned by family members.

2. A tax avoidance transaction does not include structuring a transaction in a form that results in a lower tax liability for one or more participants in the transaction than would occur if another form were used that would accomplish the same non-tax economic results.

3. In determining whether written tax advice concerning a transaction is subject to the covered opinion requirements, all components of the transaction should be considered as a whole and not individually.

4. A marketed opinion is written tax advice that the practitioner knows or has reason to know will be used by the recipient to solicit participation in the

transaction discussed in the written advice by one or more persons who have no relationship with the recipient. The relationship described in the previous sentence includes an employer-employee relationship and an owner and entity relationship. In addition, the relationship includes parties involved in the transaction other than a person whose only involvement is investing in the transaction as new passive investor (as opposed to an existing passive investor).

C. Preliminary Advice.

1. Preliminary advice includes written advice in response to an inquiry about one or more tax issues that does not include a discussion of the overall tax consequences of the proposed or hypothetical transaction. A response to an inquiry will be treated as preliminary advice if (1) the response clearly states that the response only covers the specific question or questions raised in the inquiry and is not advice as to the overall tax consequences of the proposed or hypothetical transaction or (2) it is clear from the context of the response that it is not advice as to the overall tax consequences of the proposed or hypothetical transaction

2. If a practitioner gives written advice that would be treated as preliminary advice if a covered opinion were to be rendered at a later date and the transaction does not take place, the earlier written advice need not satisfy the requirements of a covered opinion or other written tax advice.

D. Other Issues.

1. Although a practitioner may not assume a business purpose with respect to a transaction, the practitioner may point out that a business purpose is required to achieve the intended tax benefits regardless of the existence of evidence that there is, in fact, a business purpose for the transaction.

2. Although a statement in written tax advice is prohibited if it addresses the likelihood that the return disclosing the transaction would be audited or that the tax issues involved would be raised on such an audit, the practitioner may discuss the likelihood of a favorable result if the issue is raised on audit.

VII. Issues for Estate Planning Practitioners

A. Observations Regarding Covered Opinions and Other Written Advice.

1. Preliminary advice is not treated as a covered opinion if the practitioner is reasonably expected to provide subsequent written advice to the client that will satisfy the requirements of a covered opinion.

2. The written advice required for a covered opinion must deal with a federal tax issue – defined as a question concerning the federal tax treatment of an

item of income, gain, loss, deduction, or credit; the existence or absence of a taxable transfer of property; or the value of property for federal tax purposes. Does this mean advice about the tax status of an entity such as an S corporation is not a covered opinion but could be other written advice?

3. Not all written advice dealing with federal tax issues will be treated as covered opinions, except for listed transaction opinions and tax avoidance opinions, as well as marketed opinions and opinions subject to conditions of confidentiality or contractual protections. For example, the IRS may not have a reasonable basis for a successful challenge or the resolution of a challenge may not have a significant impact on the overall federal tax treatment of the transactions or matters addressed in the opinion.

4. Standard written communication with clients, not just formal legal opinions, may be subject to some of the requirements. Email falls within the written advice definition. Many IT formatting and other issues arise with email communications.

5. Malpractice concerns may dictate compliance with the best practice standards even though they are not mandatory.

6. Because most estate planning work typically involves a principal purpose other than tax avoidance, practitioners may inadvertently overlook the Circular 230 rules when advising on intrafamily transactions and aggressive techniques.

7. Most written communications not involving a listed or tax avoidance transaction will not be treated as covered opinions because the communications likely will not rise to the level of a reliance opinion.

8. Avoiding covered opinion status is important if the advice will not include a complete analysis of all significant tax issues.

9. A limited scope opinion may be appropriate in many situations.

    a. For example, in the case of an FLP, the opinion may exclude any advice as to valuation discounts or the possible application of I.R.C. § 2036.

10. Compliance with best practices should reduce the likelihood of a violation of the mandatory provisions of Circular 230.

11. Best practices should be followed by paralegals and other staff as well as by the lawyers.

12. Oral advice is not subject to the covered opinion rules, but cell phone text messages may be. What about written advice after a transaction or tax reporting that was based on oral advice?

13. All should be familiar with the 30 or so listed transactions in order to avoid advising on a transaction that is substantially similar to a listed one.

14. Non lawyers in the firm can create problems. For example, a paralegal or fiduciary accountant may be sending an email to a trust or estate beneficiary regarding the lawyer's determination of how to handle a difficult issue.

15. The final regulations to Circular 230 may be to our practice what Sarbanes-Oxley is to the practice of our corporate partners.

B. Estate Planning Techniques Potentially Affected. Most estate planning and estate administration techniques, elections, and transactions involve tax advice. Depending on the facts and circumstances, advice regarding many of the following, as well as other standard transactions, could be subject to some portion of Circular 230 after the effective date of the final regulations:

1. Creation of *Crummey* life insurance trust

2. Formation of FLP or LLC

3. S election or check-the-box tax status

4. Creation of "defective" grantor trust

5. Sale to grantor trust

6. Allocation of GST exemption

7. GRATs and QPRTs

8. Charitable remainder trusts

9. 529 plans

10. Intrafamily sales

11. AFR loans

12. Stock redemptions in family corporations

13. Assets included and excluded from the gross estate

14. 2032 alternate valuation

15. QTIP election

16. Issuance of *Graegin* note

17. Determination of basis

18. *Mellinger* discount

19. Treating capital gains as part of DNI

VIII. Analyzing a Transaction under Circular 230

A. Introduction.

1. The following list of questions is designed to assist the practitioner in determining whether written tax advice is subject to the covered opinion requirements under the final amendments to Circular 230.

2. Keep in mind that how certain terms are defined will have an impact on whether written advice will be subject to the covered opinion requirements.

3. As mentioned above, it is hoped that the IRS will issue additional guidance on the definitions of a tax avoidance transaction, marketed opinion, and preliminary advice.

B. Questions.

1. Answer the following questions to determine whether or not advice is subject to the required opinion requirements.

2. Questions:

a. Is the advice in writing, including an email and, perhaps, a cell phone text message? If the answer is no, the advice is not subject to the covered opinion requirements. If the answer is yes, go to question b.

b. Is the written advice preliminary advice? If the answer is yes, the written advice is not subject to the covered opinion requirements. If the answer is no, go to question c.

c. Does the written advice concern a federal tax issue, which is a question concerning the federal tax treatment of an item of income, gain, loss, deduction, or credit, the existence or absence of a taxable transfer of property, or the value of property for federal tax purposes? If the answer is no, the written advice is not subject to the covered opinion requirements. If the answer is yes, go to question d.

d. Does the written advice concern a listed transaction as defined under Treas. Reg. Section 1.6011-4(b)(2) (or a substantially similar transaction)? If the answer is yes, the written advice must satisfy the covered opinion requirements. If the answer is no, go to question e.

e. Does the written advice concern any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, the principal purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code (a tax avoidance transaction)? If the answer is yes, the written advice must satisfy the covered opinion requirements. If the answer is no, go to question f.

f. Does the written advice concern a qualified plan? If the answer is yes, the written advice is not subject to the covered opinion requirements. If the answer is no, go to question g.

g. Is the written advice a state or local bond opinion? If the answer is yes, the written advice will be subject to requirements similar to those that apply to a covered opinion once the proposed regulations are finalized. If the answer is no, go to question h.

h. Is the written advice included in documents required to be filed with the Securities and Exchange Commission? If the answer is yes, the written advice is not subject to the covered opinion requirements. If the answer is no, go to question i.

i. Is the written advice post return advice? If the answer is yes, the written advice is not subject to the covered opinion requirements. If the answer is no, go to question j.

j. Is the written advice given by an employee to an employer with respect to the employer's tax liability? If the answer is yes, the written advice is not subject to the covered opinion requirements. If the answer is no, go to question k.

k. Is the written advice a negative opinion? If the answer is yes, the written advice is not subject to the covered opinion requirements. If the answer is no, go to question l.

l. Does the written advice concern any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, a significant purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code? If the answer is no, the written advice is not subject to the covered opinion requirements. If the answer is yes, go to question m.

m. Is the written advice a marketed opinion? If the answer is yes, the written advice must satisfy the covered opinion requirements unless there is a disclosure. If the answer is no, go to question n.

n. Is the written advice an opinion subject to conditions of confidentiality or contractual protection? If the answer is yes, the written advice must satisfy the covered opinion requirements. If the answer is no, go to question o.

o. Does the written advice conclude at a confidence level of more likely than not (a greater than 50% likelihood) that one or more significant federal tax issues would be resolved in the taxpayer's favor? If the answer is no, the written advice is not subject to the covered opinion requirements. If the answer is yes, the written advice is a reliance opinion and must satisfy the covered opinion requirements unless there is a disclosure.

(1) A federal tax issue is only significant if the IRS has a reasonable basis for a successful challenge and the resolution of the challenge could have a significant impact, whether beneficial or adverse and under any reasonably foreseeable circumstances, on the overall federal tax treatment of the transactions or matters addressed in the opinion.

3. Written tax advice that is not subject to the covered opinion requirements must satisfy the other written advice requirements.

C. <u>Limited Scope Opinions</u>.

1. A limited scope opinion, which requires a disclosure, is one way to reduce the cost of providing tax advice.

2. However, under the Regulations, a limited scope opinion may not be provided with regard to a listed transaction opinion, a tax avoidance opinion, or a marketed opinion.

D. <u>Permitted and Required Disclosures.</u>

1. A reliance opinion is not subject to the covered opinion requirements if it discloses that the written advice is not intended or written by the practitioner to be used, and that it cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer.

2. A marketed opinion that does not concern a listed transaction or a tax avoidance transaction is not subject to the covered opinion requirements if it discloses that:

    a. The advice was not intended or written by the practitioner to be used, and that it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer;

    b. The advice was written to support the promotion or marketing of the transaction(s) or matter(s) addressed by the written advice; and

    c. The taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

3. A covered opinion must disclose the existence of any compensation arrangement or any referral agreement between the practitioner and a promoter of the transaction.

4. A marketed opinion that is subject to the covered opinion requirements must disclose that:

    a. The opinion was written to support the promotion or the marketing of the transaction(s) or matter(s) addressed in the opinion; and

    b. The taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax adviser.

5. A limited scope opinion subject to the covered opinion requirements must disclose that:

    a. The opinion is limited to one or more federal tax issues addressed in the opinion;

    b. Additional issues may exist that could affect the federal tax treatment of the transaction or a matter that is the subject to the opinion and the opinion does not consider or provide a conclusion with respect to any addition issues; and

    c. With respect to any significant federal tax issues outside the limited scope of the opinion, the opinion was not written, and cannot be used by the taxpayer, for the purpose of avoiding penalties which may be imposed by the taxpayer.

6. A covered opinion that fails to reach a more likely than not conclusion with respect to one or more significant federal tax issues must disclose that:

a. The opinion does not reach a conclusion at a confidence level of at least more likely than not with respect to one or more significant federal tax issues addressed by the opinion; and

b. With respect to those significant tax issues, the opinion was not written, and cannot be used by the taxpayer for the purpose of avoiding penalties that may be imposed by the taxpayer.

E. <u>Covered Opinion Requirements</u>.

1. Factual Matters.

a. The practitioner must identify in separate sections all factual assumptions and all factual representations, statements, or findings of the taxpayer, relied on by the practitioner.

b. The practitioner may not rely on either unreasonable factual assumptions or unreasonable factual representations, statements, or findings of the taxpayer.

2. The practitioner must relate the law to the facts.

3. The opinion must consider all significant federal tax issues unless the practitioner is providing a limited scope opinion or is relying on the opinion of others.

4. The opinion must provide the practitioner's conclusion as to the likelihood that the taxpayer will prevail on the merits with respect to each significant federal tax issue considered in the opinion.

a. If the practitioner is unable to reach a conclusion with respect to one ore more of those issues, the opinion must state that the practitioner is unable to reach a conclusion with respect to those issues.

b. The reasons for the conclusion must be stated.

5. The opinion must provide the practitioner's overall conclusion as to the likelihood that the federal tax treatment of the transaction or matter that is the subject of the opinion is the proper treatment and the reasons for that conclusion.

a. If the opinion is a marketed opinion, the opinion must reach a more likely than not conclusion.

b. If the practitioner is unable to reach an overall conclusion, the opinion must so state and describe the reason.

IX. Estate Planning Hypothetical

1. You receive a telephone call from an existing client inquiring about the tax benefits of using a family limited partnership ("FLP"). You spend one-half hour discussing the transfer tax savings that may be achieved through a FLP because of the lack of control, lack of marketability, and other discounts that may apply to the valuation of an interest in such entities.

2. The client calls you the next day and asks that you send him a letter spelling out the tax benefits of an FLP that you discussed with him on the telephone the day before. The client has not expressed any specific intention of creating an FLP.

3. After receiving the letter, the client calls you back and tells you that he has several parcels of undeveloped property that he is thinking about transferring to an FLP. He intends to have the property developed for residential use in the near future. He asks you for your advice concerning the tax consequences of transferring the real estate to the FLP.

4. The client calls you back the next day and asks you to send him a letter concerning your discussion the day before about the tax consequences of transferring the property to the FLP.

5. The client calls you the next day and tells you that he would like to have his wife as a general partner and his three children as initial limited partners in the FLP and asks you the tax consequences if they each contribute a small amount of cash to the FLP in exchange for limited partnership interests. You discuss with him the investment company rules under Internal Revenue Code ("IRC") § 721 and other issues that may arise in connection with the formation of the proposed limited partnership.

6. The client calls you back the next day and asks you to send him a letter describing all of the potential tax consequences with respect to the formation of the FLP and possible gifts of limited partnership interests to his three children.

7. The client calls you a week later and asks you to prepare the limited partnership agreement for the FLP, the deeds transferring the unimproved property to the FLP, and any other documents you feel necessary to form the partnership. You prepare a draft of a limited partnership agreement and send it to him.

8. Several days later he calls you and tells you that the agreement is satisfactory, whereupon you prepare a final partnership agreement, a certificate of limited partnership, and deeds transferring the property to the limited partnership. Note that the limited partnership agreement you drafted reflects the fact that his wife and children are putting up small amounts of cash and that his wife is receiving a 1% general partnership interest and his children are each receiving a 1% limited partnership interest. You also advise him to obtain an appraisal of the real estate and of an interest in the entity. He tells you he will use the current assessed value for the real estate and will assume a 45% discount for valuing a limited partnership interest in the partnership.

9. After the limited partnership agreement has been signed by all five of the initial partners, the certificate of limited partnership has been recorded, and the deeds transferring the property to the FLP have been recorded, you prepare a binder that contains all of the relevant documents, including your earlier letters to the client and you send it to the client for his records.

10. A month later, the client calls you and tells you he is now ready to make gifts of interests in the FLP to his three children and asks you to prepare the deeds of gift to carry out his intentions.

11. Several months later the client calls you and tells you that he wishes to transfer additional interests in the FLP to his children, but does not want to make any more taxable gifts and asks you if you have any suggestions. You discuss with him the possibility of using a sale to a grantor trust or a transfer to a grantor retained annuity trust ("GRAT") as a way of avoiding additional taxable gifts and as a way of retaining income from the transferred assets for a limited period of time.

12. The client calls you back the next day and asks you to send him a letter describing the tax consequences of a GRAT.

13. A week later the client calls and asks you to prepare a trust agreement for the GRAT and the deeds of gift necessary to transfer interests in the FLP to the GRAT.

14. A month later the client calls and asks you to send him a letter describing the tax consequences of a sale to a grantor trust.

15. Two weeks after you send the letter describing the sale to a grantor trust technique, the client calls you and asks you to prepare three grantor trusts, one for each of his children, and the other documents necessary to carry out the sales, including the purchase agreements and installment notes.

16. Several months later, the client calls you and tells you that he and his wife would like to come in to review their current estate plan. In preparation for the meeting, he asks you to send him a letter detailing his current estate plan, which includes the transactions described above as well as several other items that you have prepared for him in the past. These include an irrevocable life insurance trust that was set up several years ago to hold a last-to-die policy insuring him and his wife, trusts set up for each of his five grandchildren to take advantage of the generation skipping transfer tax annual exclusion, and wills and trusts for him and his wife that take advantage of the maximum marital deduction when the first spouse dies and provides for the funding of a generation skipping transfer trust at the death of the survivor using the generation skipping transfer tax exemptions of both spouses through the use of a reverse QTIP trust.

X. Suggested Disclosure Statement for Preliminary Advice

The following is a suggested statement that would be inserted as a separate paragraph in emails and letters that a practitioner intended to be preliminary advice:

Please note that the information contained in this [email/letter] is not intended to be advice that can be relied on to avoid any penalties that the Internal Revenue Service may assert because of a successful challenge to the tax treatment suggested. If it is later determined that a covered opinion, as that term is defined in Treasury Regulations dealing with written tax advice, is required, or is desired to avoid penalties, a more comprehensive discussion of the relevant facts and federal tax issues will be provided.

Note that the statement refers to "information" rather than "advice" and contemplates that there will be one of seven possible results, assuming the opinion is not a marketed opinion or an opinion subject to conditions of confidentiality or contractual protection:

1. The contemplated transaction does not occur and there is no need to determine whether a covered opinion is necessary.

2. It is determined that the transaction is either a listed transaction or a tax avoidance transaction and a covered opinion is required.

3. It is determined that the transaction is a significant purpose transaction and there is at least one significant federal tax issue involved, and a more-likely-than-not opinion is desired by the client; therefore a covered opinion is required.

    a. A limited scope opinion may be appropriate.

4. It is determined that the transaction is a significant purpose transaction and there is at least one significant federal tax issue involved, and a more-likely-than-not opinion is not desired by the client; therefore a covered opinion is not required, but a disclosure statement is required if the opinion would be a more-likely-than-not opinion.

5 It is determined that the transaction is a significant purpose transaction and there is at least one significant federal tax issue involved, and a more-likely-than-not opinion is not desired by the client and the opinion is not a more-likely-than-not opinion; therefore a covered opinion is not required and no disclosure statement is necessary.

6. It is determined that the transaction is a significant purpose transaction and there is no significant federal tax issue involved; therefore a covered opinion is not required and no disclosure statement is necessary.

7. It is determined that the transaction is not a significant purpose transaction; therefore a covered opinion is not required and no disclosure statement is necessary.

KENTUCKY ESTATE PLANNING & ADMINISTRATION CASE LAW UPDATE

Kentucky Probate and Trust Cases: March 2004 to May 2005

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SECTION B

KENTUCKY ESTATE PLANNING & ADMINISTRATION CASE LAW UPDATE

Kentucky Probate and Trust Cases: March 2004 to May 2005

KENTUCKY ESTATE PLANNING & ADMINISTRATION CASE LAW UPDATE
Kentucky Probate and Trust Cases: March 2004 to May 2005[1]

I. Privity

Cave v. O'Bryan
Not to be Published, No. 2002-CA-002601-MR
Rendered: 4/23/2004
Discretionary Review Granted, No. 2004-SC-407-DG, 2/9/2005
Cross-Motion Granted, No. 2005-SC-118-DG, 4/23/2005

Plaintiff-appellant's uncle went to a lawyer for an estate plan. Unfortunately, that lawyer became the appellee. Uncle, childless owner of approximately $80,000 in realty and $112,000 in personalty, wanted to leave realty to wife of 15 years (his second wife) and to split personal property between his sisters and nephews (including plaintiff-appellant). Appellee-lawyer prepared deed conveying realty to uncle and wife jointly with right of survivorship and will leaving personalty to sisters and nephews. Wife renounced will thereby cutting other beneficiaries' interests by about one-half. Appellant sued alleging appellee failed to advise uncle of effect of renunciation; appellee said he was just doing what client directed.

The Circuit Court dismissed action, finding no apparent evidence of legal negligence and that appellant-beneficiary lacked standing. The Court of Appeals reversed. Focusing on standing, it held that the plaintiff-appellant-beneficiary's lack of privity with the appellee-lawyer did not bar his legal malpractice action. The estate planning attorney "owed a duty of care to the *direct, intended, and specifically identifiable* beneficiaries of the estate planning client, notwithstanding a lack of privity." (Emphasis added.)

II. Constitutionality of Living Will Directive

Woods v. Commonwealth
442 S.W.3d 24 (Ky. 2004)

In this 69-age opinion, including a concurrence and a dissent, the Supreme Court held that KRS 311.631 is constitutional and requires that for an adult patient without decisional capacity who has not executed an advance directive, "the withdrawal of life support from a patient is prohibited absent clear and convincing evidence that the patient is permanently unconscious or in a persistent vegetative state and that withdrawing life support is in the patient's best interest." The Court's opinion includes a detailed review of the 1990 Living Will Directive legislation, the *DeGrella* case, and the 1994 amendments to the Living Will Directive statutes.

[1] Mike Stevens, Esq. of Louisville deserves credit for publishing the Louisville Law Wire, available online at www.LouisvilleLaw.com, a weekly e-mail newsletter reporting published and unpublished opinions of the Kentucky courts. In addition, Mr. Stevens contributed to the digests of the following cases that appear in this manuscript: *Cave v. O'Bryan, Gee v. Brown, Hart v. Hart,* and *Oyler v. Thomas.*

Note: The 2004 General Assembly amended KRS 311.631 to specify that the determination of decisional capacity is made by the patient's physician and that the person's attorney-in-fact (assuming the power of attorney includes authority with respect to health care) is next in line after the guardian to make the withdrawal decision.

III. Fiduciary Duty

A. *Godfrey v. PNC Bank of Kentucky*

Not to be Published, No. 2002-CA-002213-MR
Rendered: 5/28/2004

During her lifetime, Opal Godfrey Brennan amassed significant wealth and set up an inter vivos trust with Citizens Fidelity Bank, the predecessor to PNC. She executed what proved to be her final Will in 1991. That Will eliminated all bequests to individuals and left well over five million dollars to charity. A group of her relatives brought a will contest action, which they settled with PNC as Executor for $1.43 million. As part of that settlement, PNC as Executor assigned any claims the Executor might have against any third party to the group of relatives. PNC as Executor made no warranty or representation about the validity of that assignment. After the settlement, the group of relatives pursued a claim against PNC in its individual capacity for permitting "Mrs. Brennan to dispose of a portion of her income to various people" during her lifetime. PNC, in its individual capacity, defended that claim by arguing that a breach of fiduciary duty claim was similar to a legal malpractice claim and that an assignment of such a claim was therefore void as against public policy. The Circuit Court agreed and entered summary judgment. PNC, in its individual capacity, also argued that the assignment violated "the anti-champerty provisions of KRS 372.060." The Court of Appeals disagreed and held that the appellants had standing to pursue claims against PNC in its individual capacity. The Court remanded the case to the trial court to consider the merits of the claim.

B. *Longmeyer v. Bank One, Kentucky, N.A.*

Not to be Published, No. 2004-CA-000458-MR
Date: 3/25/2005

This case concerns a trustee's fiduciary duty to various parties to a trust agreement. In 1984, Ollie Skonberg made a revocable trust with the bank as trustee. She amended it in 1987 and named certain charities as remainder beneficiaries. In 1997, she exercised her right to revoke it and made a new trust with an attorney as trustee; in that new trust, she did not name the charities as remainder beneficiaries. The bank served as the new trustee's investment agent for a brief period. After Ms. Skonberg died, the trustee informed the charities about its concerns that the new trust was the result of undue influence. A will contest followed, and it was settled for a substantial sum of money. The new trustee then brought a claim against the former trustee, alleging a breach of its fiduciary duty. The trustee won a summary judgment, but the Court of Appeals is sending it back.

The Court of Appeals held that the trustee could have challenged the revocation, but once it accepted the revocation and served as the new trustee's agent, it could no longer provide confidential information to the charities that had been named as remainder beneficiaries. The Court of Appeals remanded the case. Judge Knopf added a concurrence criticizing the majority for seeming to hold that the trustee had breached its duty as a matter of law and indicating the factual issues for trial.

Note: The facts are sketchy but it appears that only two months or so passed between Ms. Skonberg's revocation of the trust and her death. Under the Court's holding, could a trustee that learned of the undue influence after accepting the revocation not act on that knowledge? If the trustee had intended to challenge the revocation and to defend the trust, it would have been faced with using the Settlor's own money to argue that the Settlor was under undue influence. Since that's not realistic, it seems like the Court's opinion furthers the cause of those who want to cover up undue influence.

IV. Claims Against Estates

A. *Estate v. River Downs Investment Co.*
159 S.W.3d 820 (Ky. App. 2005)

This case proves that the Kentucky claims procedure continues to vex attorneys. Here, a telephone betting company obtained a promissory note for payment of gambling debts. KRS 372.010 makes such notes void. After the bettor died and a claim was filed, the Executor sent a letter asking for more information. That letter stated that it was not rejecting the claim. The creditor didn't respond and the Executor didn't disallow the claim until two years and nine months after appointment. The Campbell District Court held that the Executor allowed the claim by not rejecting it, and this was upheld on appeal to the Campbell Circuit Court. The Court of Appeals held the same way and distinguished *Patterson v. Estate of Boone*, Ky. App., 150 S.W.3d 58 (2003). In that case the delayed disallowance resulted from the complexity of the claim; in the *River Downs* case, there was no explanation. The Court of Appeals also held that the claim was collectible even though it was void under KRS 372.010. Thus, "void" does not always mean "void."

B. *Gregoire v. Estate of Heick*
Not To Be Published, No. 2003-CA-000299-MR
Rendered: 6/11/2004

The executor of wife's estate made two claims against husband's estate. The executor of husband's estate did not deny the claims within the 60-day statutory period. The Executor moved the District Court to allow for a late denial of the claims, but the District Court denied the motion. He appealed to the Circuit Court, which affirmed. Proving his persistence, he then filed an original action in Circuit Court, arguing that it had exclusive jurisdiction of this contested probate matter. The Circuit Court dismissed the action for failure to state a claim upon which relief could be granted, and the Court of Appeals affirmed, noting that allowing an original action as an end run would make the 60-day limitations period of KRS 396.055 meaningless.

C. ***Quackenbush Estate v. Ruf***
Not to be Published, No. 2002-CA-001445-MR
Rendered: March 12, 2004

During Mr. Quackenbush's lifetime, Mr. Ruf worked on his farm equipment. After Mr. Quackenbush passed away, Mr. Ruf tried to collect from the widow. When she did not pay him, he filed a proof of claim in Mr. Quackenbush's estate. The widow-executrix did nothing, and Mr. Ruf brought a circuit court action. After a trial before the Court, Mr. Ruf obtained a judgment for part of his claim. The widow-executrix brought this appeal. The Court of Appeals held that the circuit court did not have jurisdiction because the executrix's failure to respond to the claim meant that she allowed it. The District Court has exclusive jurisdiction over non-adversarial probate matters, KRS 24A.120(2), and the Court of Appeals may raise subject matter jurisdiction on its own initiative even though none of the parties had done so. The Court of Appeals vacated the Circuit Court's judgment and dismissed the action.

Query: Since the claim is deemed allowed, it looks like the widow-executrix's appeal results in a worse result. The Circuit Court judgment was for only part of the claim. Now that the claim is allowed, it must be paid in full. Try explaining to your client how an appeal leaves her worse off.

V. Beneficiary Designations

A. ***Childers v. Childers***
Not to be Published, No. 2002-CA-001826-MR
Rendered: 6/18/2004

An ex-wife, a live-in romantic roommate, and a current wife all claimed to be the beneficiary of the decedent's life insurance policies. In their property settlement agreement, the ex-wife and decedent had waived interest in each other's life insurance policies and reserved the right to change the beneficiaries. The Court of Appeals upheld the Jefferson Circuit Court in following the plain language of the beneficiary designations that left the ex-wife the winner. The Court of Appeals noted that the decedent had over 15 years to exercise his right to make the changes. This type of bright-line rule has the traditional advantage of certainty and the corresponding disadvantage of at least seeming inequity.

B. ***Hart v. Hart***
Not To Be Published, No. 2002-CA-002338-MR
Rendered: June 11, 2004

Before his death, the appellant's husband signed new beneficiary forms for his annuities. He did this to remove his wife as a beneficiary. Although he did not mail the forms to the insurer, the signed forms were found among his papers after his death. Noting that "[t]he substantial compliance doctrine has been interpreted more liberally in Kentucky than in other states," the Court held that the decedent has successfully changed the beneficiary of his annuity contract. "Indeed, the attitude of Kentucky courts toward beneficiary changes has even been described as 'very liberal.' *Pikeville Nat. Bank & Trust Co. v. Shirley*, 281 Ky. 158, 135 S.W.2d 431, 433 (1939)." Substantial compliance has been found to exist when "'the insured had done all he could do under the circumstances'; 'all he believed necessary to effect the change' or 'what the ordinary layman would believe was all that was necessary to accomplish the change'." *Hill v. Union Central Life Insurance Co.*, Ky., 513 S.W.2d 808, 808-09 (1974) (citations omitted)."

VI. Contract to Make Will

A. ***Gibson v. Fite***
Not To Be Published, No. 2004-CA-000014-MR
Rendered: Jan. 21, 2005

Decedent's children brought a circuit court action alleging a contract to make a will and undue influence. In support of that claim, they sought to compel their stepmother to produce the will so they could petition for its probate. The stepmother objected because all of the assets passed to her by right of survivorship (which was why her step kids were suing her) and thus probate was not necessary. The district court ordered the will probated and appointed the stepmother as executrix. The action resumed in the circuit court, which awarded summary judgment to the stepmother on the contract to make a will claim because the contract was not in writing or expressed in the now probated will. The court also ruled against the children on the undue influence claim because they had offered the will for probate and the court held that they were thus estopped from arguing that it was void. The Court of Appeals distinguished cases decided prior to the new Rules of Civil Procedure and held that the alternate pleading rule of CR 8.05(2) allowed the children to both probate the will and argue that it was procured by undue influence.

B. ***Nation v. Kelien***
Not to be Published, No. 2003-CA-000782-MR
Rendered: June 11, 2004

Collis and Martha Frazier made a contract to make a will and signed a joint will giving the survivor a life estate in their farm with the remainder to be divided evenly between their two children, Rita Nation and Marvin Kelien. After Martha died, Collis sold the farm to Rita and her husband. After Collis died, Marvin brought this action to rescind that deed. Both the Circuit Court and the Court of Appeals held that the contract to make a will satisfied the requirements of KRS 394.540 and prevented Collis Frazier from conveying the property to one of the remainder beneficiaries at the expense of the other.

Note: The dissent by Chief Judge Emberton expresses concern that undoing a fee simple deed will throw title searches into question. It would be useful to know whether the joint will was recorded after the death of the first spouse, in which case it would provide record notice of the limitation on the surviving spouse's tenancy.

VII. Statutes of Limitation

Blackerby v. Skaggs
Not to be Published, No. 2003-CA-000051-MR
Rendered: April 30, 2004

In this case, the appellant brought a negligence claim against the executor and an attorney. The Court of Appeals held that the claim was barred by various statutes of limitations, including the one-year statute found in KRS 413.245 for claims alleging negligence in providing professional services.

VIII. Bank's Liability for Deposits

A. ***Bradley v. National City Bank of Kentucky***
Not to be Published, No. 2003-CA-002711-MR
Rendered: Dec. 30, 2004

The decedent's daughter, as successor executrix, deposited tax refund checks totaling $58,716 into her personal account at National City Bank of Kentucky in October 1998. She was removed and replaced by the Public Administrator in August 2001. In January 2003, he brought an action against the bank, seeking a return of the $58,176. The bank defended on the three-year statute of limitations under KRS 355.3-118(7)(a) and won summary judgment. The Court of Appeals upheld the trial court, declining to adopt a discovery rule absent fraudulent concealment. (KRS 386.120, regarding a bank's duty for fiduciary accounts, was not before the Court.)

Practice Point: The real interest in this case for an estate planning or probate attorney is that the Public Administrator argued that he could not have discovered the cause of action until he was appointed. Nevertheless, the clock had started ticking. So, think twice before becoming a successor fiduciary or waiving the obligation of an accounting from one fiduciary to a successor. And, think twice before automatically waiving surety on the bond because the prior fiduciary may not be able to make the beneficiaries whole.

B. ***Gibson v. Citizen's National Corp.***
Not to be Published, No. 2003-CA-000243-MR
Rendered: July 2, 2004

The decedent's wife was appointed as administratrix and deposited a check belonging to the estate in her own account. She promised to pay it to the decedent's only daughter but did not do so. After a substantial payment to the daughter (somewhat less than half the amount of the deposit in question), she filed a final settlement of the estate. The daughter did not object to the settlement. After the administratrix died, the daughter filed a claim against her estate—but after the six-month bar on claims. Proving her persistence, the daughter then brought claims against the administrator of the widow/administratix's estate and the bank at which that derelict deposit was made. It should come as no surprise that her suit failed.

The case does include a brief discussion of KRS 386.120, which protects a bank that allows a fiduciary to deposit estate funds into a personal account unless the bank has actual knowledge or acts in bad faith.

IX. Procedure

A. ***Henderson v. Thomas***
129 S.W.3d 852 (Ky. App. 2004)

At first, it looked like this case would require the Court of Appeals to squarely address fraud on the dower, but the Court based its decision on a procedural fault. Here, the estranged but not divorced husband of the decedent filed a complaint in Circuit Court alleging that his wife and stepdaughter had committed fraud on the dower by transferring personal property out of the wife's estate prior to her death but after she was diagnosed with a terminal condition. On the morning of trial, the Circuit Court dismissed the action based on the husband's failure to renounce the will. The Court of Appeals upheld that dismissal and noted that a spouse who wants to claim a dower right must renounce the will. Because the husband had never renounced the will, he had no dower right and therefore had no standing to allege that his right was fraudulently reduced by the transfers. In response to the husband's argument that his Circuit Court complaint tolled the requirement, the Court of Appeals held that this argument was not presented to the Circuit Court. Even if it had been, the Court of Appeals emphasized that the only way to renounce a will was the prescriptive procedure specified in KRS 392.080(1).

Comment: The reason for the estrangement was the husband's admitted marital infidelity. Thus, one of the issues for the trial would have been whether the husband had voluntarily left his wife and lived in adultery, which would have barred his dower claim. KRS 392.090(2).

B. ***Hahn v. Hahn***
Not to be Published, No. 2003-CA-001612-MR
Rendered: July 30, 2004

In this case, the appellants and the appellees are all nieces, nephews, grandnieces, and grandnephews of William Hahn. Mr. Hahn had left his farm to the appellees. However, prior to death, he sold the farm to one of the appellees. After his death, the appellees sought a determination that the sale did not constitute an ademption. The court also addressed the issue of whether to use the sale price or date of death value if there was not an ademption and whether to trace the proceeds. The court ruled on the latter issues and included the magic language that its order was final and appealable and that there was no just reason for delay. Nevertheless, the Court of Appeals held that the Order was truly interlocutory because the court never ruled on the ademption questions. Thus, it did not resolve the parties' claims and was not subject to appeal.

Note: Although more of an appellate procedure than estate administration case, this case does have particular relevance when a fiduciary petitions the court for instruction.

C. ***Keenan v. Estate of Glada Ethel Johnson***
Not to be Published, No. 2002-CA-000056-MR
Rendered: June 18, 2004

In an unremarkable case, the beneficiaries disagreed whether to sell or divide real property, had a successful settlement conference in Circuit Court, and then disagreed about the settlement. The case was transferred from one Circuit Court division to another so the first judge could be a witness if needed. The second judge entered an order settling the case on different terms than the original proposed settlement order. The Court of Appeals remanded for an evidentiary hearing about whether there had been a settlement and to what the parties had agreed.

D. ***Oyler v. Thomas***
Not to be Published, No. 2003-CA-000893-DG
Rendered: Sept. 24, 2004

In this discretionary review from a Circuit Court order on appeal from the District Court, the attorney for the former administrator of an estate argued that he had standing to appeal from a district court order denying his request for fees paid by the estate, and that he was entitled to fees as a matter of law. The executor of the estate argued that the district court had been without jurisdiction to appoint the administrator and therefore had no authority to award any costs or fees to the former administrator or his attorney. The Court of Appeals agreed with the attorney that he had standing to appeal from the district court's order and therefore reversed the Circuit Court's order dismissing his appeal. Although the Court of Appeals disagreed with the Circuit Court's reasoning resolving the remaining issues, the three judges held that the district court had properly denied attorneys fees but did allow the former administrator to recover some costs incurred during his administration of the estate.

The Court's discussion of the District Court's jurisdiction is interesting. The Court seems to hold that testamentary capacity and undue influence are inherently adversarial and the District Court does not have jurisdiction over them. However, the District Court retains jurisdiction until a Circuit Court action is filed. Thus, the mere mention of those issues doesn't deprive the District Court of jurisdiction.

E. ***Utterback v. Perry***
Not to be Published, No. 2003-CA-001847-MR
Rendered: March 25, 2005

Two brothers, as co-administrators of their mother's estate, obtained a District Court order requiring their sister to turn property over to the estate. She had owned it jointly with their mother. The District Court entered the order. After her appeal to Circuit Court was dismissed as not being from a final order and a 2002 trip to the Court of Appeals on the discretionary review road to nowhere highway, she went back to Circuit Court and obtained a writ of prohibition. The co-administrators then went to the Court of Appeals, which vacated the order issuing the writ and remanded with instructions to dismiss the petition. The Court noted that writs of prohibition are not favored because they "disrupt the orderly, even if erroneous, proceedings of a trial court." This writ did not satisfy either requirement for the issuance of a writ: (1) that the court acted outside its jurisdiction, or (2) that the court committed error and there was no adequate remedy by appeal or otherwise. The property involved here was a bank account and a CD and the Court noted that financial injury does not generally constitute irreparable injury.

Note: The CD was worth $30,000, but the value of the bank account was not stated. One does wonder what the net gain is after the cost of two trips to the Court of Appeals and the numerous District Court and Circuit Court hearings.

X. Document Interpretation

A. *Richardson v. Richardson*

Not to be Published, No. 2003-CA-001818-MR
Date: May 6, 2005

This case held that a qualified disclaimer may not be amended after it is made. Although that result may seem logical (how can one modify one's rights to property if one had disclaimed ever having such rights?), it would have been useful for the Court of Appeals to publish this opinion so we could add that principle to the scant case law about disclaimers in Kentucky.

The case may also be interesting to the estate planner, however, because the Court of Appeals appears to have understood a fairly complicated sequence of events. It is worth a read just to see how to explain that in a logical, concise way.

B. *Truax v. Trumbo*

Not To Be Published, No. 2004-CA-000084-MR
Rendered: Feb. 11, 2005

An inter vivos trust included conflicting language about the ultimate disposition of the trust assets. In one part, it left everything to "my children" in equal shares; in another, it stated that the "failure to provide for distribution" to the named children was intentional. Those named children became the plaintiffs, but the Court of Appeals held that their interpretation was untenable. In order to give effect to all of the documents' provisions, and recognizing that specific terms trump general ones, the Court held that the settlor's "clear intent" was not to provide for those named children.

Although unremarkable in result, this case provides a good primer on the rules for interpreting trusts.

XI. Life Estate

Gee v. Brown
144 S.W.3d 844 (Ky. App. 2004)

Appellant, the Executrix of Ms. Pinchum's estate, argued that she had the power to convey fee simple title to a piece of property in which the decedent had been granted a life estate. The decedent had filed a 1967 Affidavit of Descent purportedly renouncing her life estate and putting the remainder beneficiaries on constructive notice that she was claiming ownership of the fee by adverse possession.

Appellant relied heavily on selected passages from *Superior Oil Corp. v. Alcorn*, 242 Ky. 814, 47 S.W.2d 973 (1931), in support of her argument that a life tenant may acquire the fee by clearly renouncing all claims as life tenant to the knowledge of the remaindermen, and by taking possession under a claim of absolute ownership with recorded evidence of his or her title to that effect. The Court's careful reading of *Superior Oil*, however, supported the decision of the trial court. The court in *Superior Oil* plainly stated "[w]e have found no case, in this state, where one having nothing but a life estate has been able by any act or declaration **of his own** to enlarge that life estate to a fee." 242 Ky. at 826, 47 S.W.2d at 980 (emphasis added by *Gee*).

TRANSFERS OF PROPERTY TO CHARITY

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SECTION C

TRANSFERS OF PROPERTY TO CHARITY

Transfers of Property To Charity

Jerry J. McCoy
Washington, DC

> *"Charitable contributions of noncash items, especially art objects, have been increasing. The main problem here centers around highly inflated excessive valuations."* (from The American Way In Taxation: Internal Revenue, 1862-1963, edited by Lillian Doris, Prentice-Hall, 1963, at page 101)

I. A Long History of Distrust

Early in the life of the US Income Tax, in 1917, the Bureau of Internal Revenue was faced with a technical issue. When property (e.g., stock or artworks) was contributed to charity, was the donor's deduction based upon the value of the property or the donor's cost? Their answer – the current market value would be deductible. [See Giving in America: Toward a Stronger Voluntary Sector, Report of the Commission on Private Philanthropy and Public Needs (1975) at page 143-4 for a discussion of this unidentified ruling.] By the time regulations were promulgated under the Revenue Act of 1918, this rule was incorporated therein. See Article 251 of Regulations 45.

Thus, the donor of appreciated property received a double benefit – the gain accruing in the property escaped capital gains tax, while the allowable deduction was based on the appreciated value. When tax rates were as high as 70% (91% before 1964), the donor's tax benefit could exceed the after-tax proceeds remaining if the property had been sold. Critics pointed out that two identically situated donors giving the same amount to charity were treated differently if one gave cash while the other gave appreciated property, even though the donee charity received the same benefit.

When Congress set about revising the basic tax rules governing charitable contributions in the Tax Reform Act of 1969, one of the major concerns addressed was prevention of abuses involving property contributions. A major goal was to eliminate the possibility that a donor could "make money by giving it away," coming out ahead financially by making a charitable contribution. The deduction limitations described below were designed in part to help prevent this.

A parallel concern that has plagued tax administrators for years is the problem of ascertaining the true value of contributed property. Because the donor's deduction is based upon the fair market value of the contributed property, there is a natural human tendency to exaggerate such values. A major change in this area was the introduction of a comprehensive system of appraisal requirements for contributions of noncash property under the Deficit Reduction Act of 1984. That Act directed the IRS to promulgate regulations incorporating appraisal requirements for contributions of property exceeding certain dollar limits (generally $5,000, but $10,000 for closely-held securities). Simultaneously, Congress encouraged the IRS to utilize fully existing penalties, (e.g., negligence and fraud penalties) to further discourage valuation abuses. Five years later, in the Revenue Reconciliation Budget Act of 1989, the penalty and interest provisions were consolidated and coordinated.

The effect of the 1984 changes was to increase the likelihood that excessive valuations of contributed property would be detected by IRS and to increase the cost to donors who claim excessive deductions based on overvaluations. In 1993, as part of the Omnibus Budget Reconciliation Act of 1993, the substantiation requirements were further strengthened by the enactment of §170(f)(8), requiring receipts ("contemporaneous written acknowledgments") for all contributions over $250.

Despite this network of statutory and regulatory requirements, the problem of overvalued property contributions has not diminished over the years. In June of 2004, in connection with hearings reviewing a variety of tax and nontax problems involving nonprofit organizations, the Senate Finance Committee staff released a laundry list of legislative proposals, including a proposed new system for resolving disputed valuations. Subsequently, in January of 2005, the Joint Committee on Taxation listed overvalued charitable contributions of property as a major source of lost tax revenue and forwarded several proposals to curtail this abuse. This will be discussed below in Part V of this outline.

II. Property Contributions Are Treated Less Favorably Than Cash Contributions

A. Percentage Limitations

1. Cash contributions by individuals – Deductible up to 50% of the donor's "contribution base" (genreally equal to adjusted gross income ("AGI")

2. Appreciated property contributions by individuals – Deductible at fair market value (subject to the reduction rules described below) to the extent they do not exceed the following:

   a. Contributions of appreciated capital gain property to a public charity are deductible up to 30% of adjusted gross income. [§170(b)(1)(C)]

   b. Contributions of appreciated property to a private foundation or "for the use of" any charity are deductible up to the <u>lesser</u> of (1) 20% of adjusted gross income, or (2) the excess of 30% of AGI over all contributions to which the 30% limitation of section 170(b)(1)(C) applies. [§170(b)(1)(D)]

3. A donor may elect to reduce the amount of property contributions to his or her basis in the contributed property, and thereby render such reduced deduction allowable under the higher 50%-of-AGI rule. [§170(b)(1)(C)(iii)]

4. Contributions in excess of the percentage limitations carry over for the following five taxable years, and are treated as the same type of contribution, subject to the same percentage limitation, in the carryover years.

B. <u>Deductions Are Reduced for Certain Property Contributions</u>

In general, the amount deductible for a charitable contribution of property is the fair market value of the property on the date of the gift.

Many people (both practitioners and civilians) have the misconception that the Tax Reform Act of 1986 limited all property contributions to the donor's basis. This is not true, although there are several important exceptions.

1. Non-capital gain property

a. General rule – The amount of the donor's deduction is reduced by any amount which would not have been taxed as long-term capital gain if the property had been sold at its fair market value on the date of the contribution. See section 170(e)(1)(A). Examples of the types of gifts affected by this rule would be inventory property, short-term capital gain property, property subject to recapture under section 1245 or 1250, and section 306 stock. This rule applies without regard to the nature of the donee organization. In effect, deductions for gifts of such property are limited to the donor's basis in the property.

b. Exceptions for certain gifts of inventory property by corporations, if such gifts are:

(i) For the care of the ill, the needy or infants [§170(e)(3)]; or

(ii) "Qualified Research Contributions" [§170(e)(4)].

In each instance, there are highly detailed tests for qualification. If either of these exceptions applies, the deduction is equal to the smaller of:

The donor's basis plus half of the appreciation, or

Two times the donor's basis.

2. Capital Gain Property

a. Tangible property/unrelated use rule – If tangible personal property is contributed, and the donee organization's use of the donated property is not related to its charitable function (e.g., construction equipment donated to a symphony orchestra organization), the donor's deduction is limited to the donor's basis in the property. [§170(e)(1)(B)(i)]

b. Property gifts to private foundations (i). General rule – In general, deductions for gifts of appreciated property to a private foundation are limited to the donor's basis in the property. [§170(e)(1)(B)(ii)]

(ii). Exception – Contributions of capital gain property to the following types of private foundation (described in §170(b)(1)(E)) are deductible on the same basis as contributions to public charities:

(1) Private operating foundations (described in §4942(j)(3));

(2) Foundations which distribute all of the contributions received for a given year by the 15th day of the third month of the following year [the so-called "conduit" or "pass-thru" foundation, described in §170(b)(1)(E)(ii)]; and

(3) "pooled fund" foundations described in §170(b)(1)(E)(iii).

(iii) Publicly-traded stock – Contributions of publicly-traded stock to a private foundation are now deductible at full fair market value. Any one donor may deduct only 10% of the stock of any one corporation in this fashion. This was originally enacted as a temporary rule applicable only to contributions made from 1984 through 1994. It was revived (not extended) for contributions made from July 1, 1996, through May 31, 1997, and after many efforts, it was made permanent in 1998.

(c) Partial Interest Rule – No deduction for a contribution of less than the donor's entire interest in the property, with important exceptions (discussed below). See section 170(f)(3).

3. Bargain Sale Rules – If property is sold to a charity (i.e., if a charitable deduction is allowable by reason of a sale) the donor must allocate his/her basis in the property between the sale portion and the gift portion. [§1011(b)]

C. Special Rules For Certain Types Of Property – Congress, in the Jumpstart Our Business Strength (JOBS) Act passed last year, took a new approach to the ubiquitous problem of overvalued charitable contributions by imposing special rules for certain categories of property.

1. Patents and copyrights – The JOBS Act, added new section 170(m) to the Code, allowing a multi-year deduction for donations of intellectual property. In the year the contribution is made, the donor's deduction is equal to basis; this result is reached by reducing the deduction by any long-term capital gain inherent in the property, under new §170(e)(1)(B)(iii). Over the next twelve years the donor would be allowed to claim additional deductions based on a percentage of the royalty income received by the donee from the transferred property. This deduction would gradually decline from 100% of such income in the next two years to 10% in years 11 and 12. The donor's additional deductions don't begin until after the percentage income amounts exceed the initial deduction (basis).

   Note that new §170(e)(1)(B)(iii) achieves a parity between contributions of patents (which are capital assets, and hence were formerly deductible at fair market value) and copyrights (which are not, and thus produced – and still do – a deduction equal to the donor's cost basis).

2. Used Cars – The JOBS Bill also enacted new §170(f)(12), which imposes new rules for contributions of motor vehicles, including boats and airplanes. Deductions in excess of $500 for such contributions are limited to the gross proceeds received by the donee charitable organization upon subsequent sale of the vehicle. The proposal would require the charity to report to the donor the amount of the sale proceeds within 30 days of the date of sale.

   The new rules also require the charity to furnish certain information to the IRS, including the donor's name and tax ID number, the vehicle identification number, a certification that the vehicle was sold in an arm's length transaction between independent parties, and the sales price received. If the charity retains the vehicle for use, the taxpayer is eligible for a fair market value deduction provided that the charity and the donor provide the IRS with certifications regarding the proposed use. Charities are subject to a new penalty for providing fraudulent declarations to donors. This penalty is generally equal to the greater of the tax benefit to the donor or gross sales receipts from the vehicle.

3. More? – Might this format (donor's deduction somehow determined by what the donee realizes, rather than value) be a model for all non-cash property contributions? As Congress reviews the basic approach to these contributions, the JOBS Act changes could provide a model for charitable contributions of property generally.

4. Other New Rules for Property Contributions – In addition to the rules described above for specific types of property, the JOBS Act also amended some of the basic rules affecting property contributions in general. The qualified appraisal requirements were extended to all taxpayers, including C corporations. [Formerly, the qualified appraisal requirements applied only to individuals, partnerships and S corporations.] In addition, taxpayers must now attach a copy of the qualified appraisal to Form 8283 whenever the claimed deduction exceeds $500,000. These dollar limitations are indexed for inflation.

III. The Partial Interest Rule and the Charitable Deduction

The discussion above demonstrates how certain contributions of property produce an income tax deduction that is less than fair market value. In the discussion that follows, we will review rules that have a more drastic effect; under these rules, certain property contributions are entirely nondeductible. The existence of these rules requires the planner to be aware of their effect and to structure affected contributions in such a manner as to qualify for a deduction wherever feasible. Such planning utilizes non-trust techniques.

A. General Rule of Nondeductibility

The starting point for most of these non-trust techniques is the basic set of rules governing the income tax charitable contribution deduction. Obviously, an outright transfer of cash or property to charity will produce a deduction for the donor, but effective gift planning normally calls for a set of alternatives more creative and less obvious than that.

The essence of a planned giving technique is the availability of a simultaneous benefit of one sort or another to the donor (or his/her noncharitable beneficiary) from a charitable transfer. The Internal Revenue Code provides a general rule disallowing the donor's charitable deduction for such a transfer, but there are exceptions provided and these are the foundation for the entire field of planned giving.

In the case of transfers in trust, section 170(f)(2) requires that the transfer of a remainder interest be in the form of a charitable remainder annuity trust or a charitable remainder unitrust (described in section 664), or a pooled income fund (described in section 642(c)(5)) if a deduction is to be available. For nontrust charitable techniques, the statutory point of reference is the split interest limitation in section 170(f)(3)(A). Under that provision, no deduction is allowable for a nontrust transfer of an interest in property which consists of less than the taxpayer's entire interest in such property (unless it meets the requirements for deductibility of a trust transfer). A transfer of the right to use property (e.g., a week's use of a vacation home) is nondeductible under this rule.

B. Exceptions – The Key To Partial Interest Transfers

For planning purposes, the key to the partial interest limitation lies in the exceptions set forth in section 170(f)(3)(B). Those exceptions set the ground rules for the very common planning situation presented by the client who wants to accomplish simultaneously a personal objective and a charitable objective. Indeed, the standards in section 170(f)(3)(B) often define the planning parameters.

Obviously, section 170 (where these rules are set forth) is an income tax provision. However, these rules are adopted by cross-reference in the gift tax and estate tax charitable deduction provisions. Each of these exceptions is described and discussed in detail in Part IV below.

IV. Deductible Split Interests Define Nontrust Planning Techniques

The types of split interest transfers discussed below are deductible notwithstanding the general prohibition on deductions for charitable transfers which also provide benefits for the donor or another beneficiary.

A. Remainder Interest in a Personal Residence or Farm

A contribution of a remainder interest in a personal residence or farm qualifies for income tax, estate tax, and gift tax charitable deductions under sections 170(f)(3)(B)(i), 2055(e)(2), and 2522(c)(2), respectively.

[Note: Computation of the deduction for income tax purposes is quite complex, and straight line depreciation must be taken into account. See section 170(f)(4) and Treas. Reg. §1-170A-12. While the examples there are sufficiently complicated to confuse many readers, note that the situation is further complicated by the current actuarial system mandated by section 7520 and the monthly rate adjustments required thereunder. Most practitioners prefer to rely upon a computer program for such computations.]

The requirements for qualification are fairly simple:

1. The interest conveyed to charity must be a legal remainder interest; it may follow either a life interest or a term of years.

    a. A remainder interest in trust will not qualify; see Rev. Rul. 76-357, 1976-2 C.B. 285.

    b. It is generally not sufficient for the property to be sold at the termination of the life or term-of-years interest, and the proceeds given to the charitable donee. [Exception - Such an approach will produce a deduction if under state law the charitable remainderman may compel the life tenant's executor to distribute the property instead of selling it. See Estate of Eliza W. Blackford v. Commissioner, 77 T.C. 1246 (1981), acq. in result, 1983-2 C.B. 1, involving West Virginia law, and Rev. Rul. 83-158, 1983-2 C.B. 159.

    c. A fraction of the remainder may be given to charity with the balance held either by other charities (Rev. Rul. 83-158, 1983-2 C.B. 159) or by individuals (Rev. Rul. 87-37, 1987-1 C.B. 295).

    d. Can the donation of the remainder interest be contingent? The answer is a clear "It depends." Although a remainder interest in the residence or farm must vest in the donee charity, it may be subject to a contingent subsequent that would cause title to vest in another charity. See Private Letter Ruling No. 9436039, approving a deed of transfer providing that the initial Donee's interest would terminate and vest unconditionally in another qualified Donee if the initial Donee should attempt to sell or encumber the residence, lease it to any entity for any use other than historic preservation, or change the configuration of the first floor of the residence.

2. The residence in question need not be a principal residence. A vacation home or similar temporary residence may be used; this is often a convenient way to provide for the ultimate disposition of such a property and at the same time obtain a current income tax deduction. A cooperative apartment or condominium will also qualify.

3. A farm will qualify in its totality. That is, the deductible interest will include the improvements and acreage, and not merely the living quarters. A farm is defined in Regs. sec. 1.170A-7(b)(4) as any land used by the taxpayer or his tenant for the production of crops, fruits, or other agricultural products or for the sustenance of livestock (including cattle, hogs, horses, mules, donkeys, sheep, goats, captive fur-bearing animals, chickens, turkeys, pigeons, and other poultry).

4. The donee may be a private foundation, although this may require a reduction of the allowable income tax deduction under section 170(e)(1)(B)(ii); see Private Letter Rulings No. 9714017 and 9538040.

5. If a remainder interest is given to charity under this rule, the donor will be entitled to additional deductions upon making subsequent capital improvements (e.g., installation of a new heating and air conditioning system): see Private Letter Ruling No. 8529014.

B. Undivided Portion of Taxpayer's Entire Interest

A contribution of a undivided portion of the taxpayer's entire interest in property likewise qualifies for income tax, estate tax, and gift tax charitable deductions under sections 170(f)(3)(B)(ii), 2055(e)(2), and 2522(c)(2), respectively.

To qualify, the charitable donee must receive a fractional or percentage of each and every substantial interest or right owned by the donor, and must extend over the entire term of the donor's interest in the property and in any other property into which the property is converted. The charity is thus made a co-tenant or co-owner of the property.

Examples:

1) Donor's father bequeaths to him a life estate in an office building. Subsequently, Donor contributes to his university a 25% undivided interest in his life estate in the office building. Donor's contribution is deductible.

2) Donor contributes to his university a life estate in an office building owned by him. This contribution is not deductible, since it is not an undivided portion of the Donor's entire interest in the building.

Allocation of possession (based on time) is generally necessary; see Treas. Reg. §1.170A-7(b)(1)(i) and Private Letter Ruling No. 7733075.

This is sometimes used as a means of sharing artworks or other similar property by a donor and a charitable institution on a deductible basis.

EXAMPLE: Collector gives a university museum an undivided 25% interest in a sculpture valued at $200,000. This will normally produce a $50,000 deduction and the museum will be entitled to the unrestricted use and possession of the sculpture for 25% (i.e., three months) of each year. Two points should be noted:

1) In Winokur v. Commissioner, 90 T.C. 733 (1988), acq. 1989-1 C.B. 1, the Tax Court held that the donee's right to possession of contributed artwork during its proportionate period of ownership is sufficient, even if it doesn't actually take possession.

2) Even though the IRS has acquiesced in the Winokur case, a donor should not undertake such an arrangement unless it is contemplated that the parties will conduct themselves in accordance with the terms of their shared ownership arrangement.

3) As a practical matter, this should be undertaken only where the donee actually desires eventually to own the works in question outright, and the donor contemplates contributing them in their entirety eventually.

Note also that Treas. Reg. §1.170A-5(a)(2) requires that the donee's initial period of possession begin within one year, lest the gift be classified as one of a future interest (and hence potentially giving rise to a delayed deduction under §170(a)(3)).

C. Qualified Conservation Contributions

The final type of deductible split-interest transfer is the qualified conservation contribution, which is defined in section 170(h). The qualifications are quite technical, but may be summarized as follows:

1. There must be a contribution of a "qualified real property interest":

   a. The most familiar of these is the so-called "conservation easement" (also sometimes called a facade easement or preservation easement). This is not a traditional easement, but rather consists of a restriction (in perpetuity) on the use which may be made of the subject property.

   b. A remainder interest may also qualify.

   c. Also, the donor may contribute his or her entire interest in the property other than a "qualified mineral interest" (defined in section 170(h)(6) as subsurface oil, gas, or other minerals, and the right of access to them).

2. The contribution must be made to a "qualified organization" basically, a governmental unit or a publicly-supported charitable organization). See section 170(h)(3) for the full definition.

3. The contribution must be made "exclusively for conservation purposes." See sections 170(h)(4) and (5) and the extensive regulations thereunder for the very technical list of requirements for qualification.

4. Some special planning considerations:

   a. The conservation purpose must be "protected in perpetuity." Hence, any mortgage or other indebtedness must be subordinated to the rights of the donee organization. See Satullo v. Commissioner, T.C. Memo 1993-614, disallowing a deduction for the value of an easement which was not recorded until after a subsequent mortgage had been entered into and recorded; the court found that the mortgage lien took priority over the easement, such that the easement was not protected in perpetuity.

b. The amount of the donor's deduction for a conservation easement is generally determined by a before-and-after approach (i.e., the value of the property before the easement is imposed, less the value of the property with the easement in place).

c. Any enhancement in the value of other nearby property held by the donor as a result of the conservation contribution will reduce the deduction otherwise available. For example, by contributing an easement which obligates him to preserve the unspoiled nature of a wooded lakesite, the donor may increase the value of an adjacent cottage also owned by him. The deduction for the easement is reduced by the amount of this increase in value, and it would not be unheard of for the IRS to allege that such an increase (which is often hard to value) is sufficient to eliminate the deduction.

5. Caution! – As described below, the conservation easement is the subject of several adverse legislative proposals, and the planner should not ignore the possibility that the law could change with retroactive effect. The Chairman and ranking minority member of the Senate Finance Committee announced in December of 2004 that they would introduce legislation to block abusive conservation easement contributions and that such legislation would be effective as of the date of their press release (December 17, 2004). Earlier, the IRS issued a public warning of abuses in contributions of conservation easements (largely resulting from abusive valuations); see Notice 2004-41.

6. Although the conservation contribution usually thought of in terms of the familiar restrictive easement, note that it may also be utilized by a donor wishing to transfer the bulk of the subject property and retain subsurface oil, gas and other mineral rights. See Private Letter Ruling No. 9318027.

V. Winds of Change - Proposals, Warnings and Pending Legislation – Fears of overvalued charitable contributions are once more prompting proposed legislative solutions. Some of these solutions would affect specific types of property contributions, while others would be generally applicable.

A. Joint Committee on Taxation Proposals

In January 2004, Senate Finance Committee Chairman Chuck Grassley (R-Iowa) and Ranking Minority Member Max Baucus (D-Montana) asked the Congressional Joint Committee on Taxation to prepare a report detailing various ways Congress might reduce the widening gap between taxes actually paid and taxpayers' true tax liability – a gap of about $311 billion as of 2001. The report was to address ways to improve compliance by curtailing tax shelters, closing unintended loopholes and addressing other noncompliance issues. The request was diligently worked upon by the committee staff and it culminated in a massive collection of proposals on an extremely broad range of topics – 435 pages – released on January 27, 2005.

The Joint Committee Proposals include three items are aimed directly at property valuation abuses. The first two would modify charitable deductions for contributions of particular categories of property – specifically conservation and facade easements, and clothing and household items. A third proposal would reform the general rules governing all charitable contributions of property.

Conservation and Facade Easements

The Joint Committee characterized the process for valuing these as "highly speculative, considering that, in general, there is no market and thus no comparable sales data for such easements." To limit abuses, the proposal would make several changes, First, no deduction would be allowed for an easement on a personal residence where the donor or a member of the donor's family uses or expects to use the property as a residence. For other properties, the deduction for contribution of a facade easement would be limited to the lesser of (1) five percent of the fair market value of the structure (determined without regard to the facade easement); or (2) 33 percent of the value of the facade easement. And second, the proposal would imposes new standards on appraisals and appraisers regarding the valuation of conservation easements for contribution purposes.

Used Clothing and Household Items

To prevent abuses, deductions for contributions of used clothing and household goods would be limited to $500 per year. Household items for this purpose would not include antiques, jewelry, or collections.

Contributions of Appreciated Property

The Joint Committee suggests several alternative approaches for dealing with the perpetual problem of overvalued charitable contributions of non-cash property.

> Option 1 is the simplest – deductions for contributions of most property other than marketable securities would be limited to the donor's tax basis in the property (or its fair market value if less). Some categories of property that are dealt with specifically in the Internal Revenue Code would not be subject to this rule. Examples would include used cars (plus boats and planes), intellectual property, and contributions eligible for an enhanced deduction under sections 170(e)(3), (e)(4), or (e)(6).
>
> Option 2 would be the same, with one additional wrinkle – contributions of property to be used to substantially further the donee's exempt purposes ("exempt use" property) would continue to produce deductions equal to fair market value. If, however, the donee disposed of the property within three years, the donor's deduction would be scaled back to basis. If such disposition occurred in a subsequent taxable year (after the donor had already claimed a deduction for the value of the property, the donor would realize income in that year equal to the excess of his/her deduction taken over the basis limitation. Expanded reporting requirements would be added to enforce this rule.

In addition to these principal options, which the Joint Committee admits "is likely to reduce the amount of contributions of hard-to-value property," several other alternatives are also thrown out. For example, the present-law system of appraiser and appraisal rules could be strengthened to prevent overvaluations. Another approach suggested would be to allow the donor an initial deduction equal to his/her basis (or if less, fair market value), and the donor would be eligible for an additional charitable contribution deduction in the year the contributed property is disposed of by the donee. And finally, the report acknowledges that it might be simpler just to eliminate, in whole or in part, the charitable contribution deduction for property. The report notes, however, that "This approach would discourage much systematic and institutionalized fundraising."

The full text of the Joint Committee report is available from the House of Representatives website at **http://www.house.gov/jct/s-2-05.pdf.**

B. Senate Finance Committee "Discussion Draft" of June 19, 2004 – This document, issued in connection with Hearings held on June 22, sets forth a series of sweeping changes in the tax and non-tax rules governing charities and other nonprofit organizations. The full document is available on the Internet at ***http://finance.senate.gov/hearings/testimony/2004test/062204stfdis.pdf***. Two of the proposals in the draft would specifically affect property contributions:

1. Contributions to a donor-advised fund ("DAF") other than cash or publicly traded securities would have to be sold within one year of contribution and a plan for sale must exist at the time of gift. Alternatively, a DAF might be permitted to accept only cash or publicly traded securities

2. Baseball Arbitration Rule – The Finance Committee discussion draft would impose new rules for dealing with audit controversies arising from such disputed valuations. Because they parallel the approach used to resolve pay disputes between professional baseball players and team owners, this is referred to as the "baseball arbitration" rule. Under these rules, donors would be bound by the values claimed on a return when they receive notice that the return is to be audited. If the parties are unable to agree on a mutually acceptable settlement, the IRS auditor and the donor/taxpayer would each submit a proposed value to the IRS Appeals officer, who would be required to select one figure or the other, rather than reaching an independent conclusion. If litigation ensues, the court would likewise be limited to one of these two values. In appropriate circumstances, the court could require the losing party to pay the appraisal costs incurred by the prevailing party.

VI. Don't Forget! – FMV Remains the Basic Rule for Property Contributions

Given the decades of controversy, legislative change and the current proposals, planners must not lose sight of the basic rule that applies to these contributions. As in the 1917 ruling described at the beginning of this outline, the donor's charitable deduction for a contribution of capital gain property (i.e., most property) is still based upon the value of the property. There are plenty of exceptions, and it is easy to become so entranced by the elegant complexity of the exceptions that one forgets that these ARE only exceptions to the familiar old general rule. Most donors and most gifts are still unaffected.

VII. Special Considerations for Special Assets

A. Art Objects

1. Consider a gift of a partial interest, as described above.

EXAMPLE: R owns a Picasso painting (value $300,000) which he desires (ultimately) to contribute to Museum M, and which M very much desires. R lives in New York, but spends three months each winter in Florida. R may contribute to M a 25% undivided interest in the painting, entitling M to unrestricted use and possession of it for 25% (three months) of each year - the period when R is in Florida. R is entitled to a deduction of $75,000, or 25% of the value of the painting, and his enjoyment of the painting is virtually unaffected.

2. Loans and pledges of artworks may pose gift tax problems, primarily because they are often difficult to distinguish. For example, consider the donor who intends to give a valuable art object to charity, but wants to keep it for his or her life.

If the donor is viewed as giving the donee a future interest in the subject work and retaining a life estate, this is a transfer for which no gift tax charitable deduction is available. The result could be a gift tax.

Compare the effect if the transaction is a loan, followed by a testamentary transfer; under section 2503(g), "any loan of a qualified work of art" will not be treated as a transfer for gift tax purposes.

The moral is to try to arrange such a deferred gift of artwork whenever possible in such a manner that it will be characterized as a loan.

See Private Letter Ruling No. 9152036 for a loan/gift arrangement whereby a donor transferred her artwork to a museum over time, subject to a detailed agreement. This ruling offers a good model for such an arrangement, although it may be a good idea for a donor wishing to create a similar arrangement to seek a ruling of his/her own.

3. Consider a private operating foundation for the art collector who regularly contributes or loans artworks to museums, universities, etc.

4. Copyrighted artworks presented a unique problem under the split interest rules discussed above, but that problem was corrected by legislation in 1981. Sections 2055(e)(4) and 2522(c)(3) provide that for estate and gift taxes (but not the income tax), a work of art and a copyright on such work will be treated as separate properties; this result follows only if the donee is a public charity and its use of the property is related to its charitable purpose.

5. Artists and Collectors – All contributions of art are necessarily property contributions and as such are fully subject to the rules described above. Artists sometimes complain that they are singled out for discriminatory treatment, since their deductions for contributions of their own works are limited to the cost of materials (Why? – Because a sale of the work would produce ordinary income), while upon their death, they are subject to estate tax on the full value. This is not a result intended, but only the rsult of applying general rules to a particular factual setting.

6. Commissioner's Art Advisory Panel – The Art Advisory Panel assists the Internal Revenue Service by reviewing and evaluating the acceptability of property appraisals submitted by taxpayers in support of fair market value claims on works of art for income tax (i.e., charitable contribution) purposes and estate tax purposes. All taxpayer audits which include art work or cultural property with a claimed value of $20,000 or more are referred to the Art Advisory Panel. The Panel meets in Washington, DC usually once or twice a year in each specialty area. Approximately 250-300 items are reviewed at each one-day meeting. Prior to the meetings, the staff appraisers send photographs and written materials to the Panelists concerning the works of art to be reviewed. The written materials include information from the taxpayer's appraisal, such as size, medium, physical condition and provenance, as well as the staff's own market research, including information on public and private sales of relevant art work.

7. IRS Ruling on Value – As a general matter , the IRS will not issue advance rulings on the value of property for any purpose, since this is a factual issue . See §4.02(1) of Rev. Proc. 2004-3, 2004-1 I.R.B. 114. However, Revenue Procedure 96-15, 1996-3 I.R.B. 41, establishes procedures whereby a taxpayer may request a Statement of Value from the Service for a transfer of art that has been appraised for at least $50,000. Taxpayers may then rely upon this Statement of Value for tax return purposes. This is not often used by taxpayers because it is available only after the transfer has taken place, and the "user fee" to IRS is $2,500.

B. Life Insurance

1. A contribution (i.e., transfer of ownership) of a policy is deductible, but mere payment of premiums on a policy payable to charity is not deductible if the donor/payor still has the right to change the beneficiary.

2. Note that, due to the ordinary income rule of section 170(e)(1)(A), the donor's income tax charitable deduction for such a contribution will be limited to basis (i.e., the total premiums paid), even if the cash surrender value is higher.

3. Many "split dollar" life insurance plans involve a division of a policy into several portions, with the cash value typically being separated from the pure life insurance portion. Remember that such gifts are subject to the partial interest rules discussed above. Thus, where the donor transfers a policy to charity but retains the right to designate the beneficiary of a portion of the proceeds, or to receive the proceeds in excess of the cash surrender value, the transfer of the policy (or payment of the premium) has been held not to qualify for the income tax charitable deduction of the gift tax charitable deduction. See Rev. Rul. 76-143, 1976-1 C.B. 63, and Rev. Rul. 76-200, 1976-1 C.B. 57, respectively.

4. Private Letter Ruling 9110016 held no charitable deduction allowable for the transfer of a newly-issued policy as a result of the interplay of two rules of New York insurance law: (1) a charity does not have an insurable interest in a donor's life; and (2) the insured's estate may be able to recover proceeds paid to a beneficiary who lacked an insurable interest. According to I.R.S., the lack of an insurable interest cannot be cured merely by having the insured take out the policy and immediately transfer it to the charity, based upon a substance-over-form analysis. This is a controversial holding, and if upheld it would invalidate many long-established life insurance contribution programs. Although it may be based upon a strained reading of New York law, note that several other states have parallel law which raises the same issues.

5. "Wealth replacement" insurance is often used in conjunction with other charitable gifts, to make up for the reduction in property otherwise passing to the family after the donor's death. Typically, a donor who creates a charitable remainder trust will use either the distributions from the trust or the income tax savings from the charitable deduction produced upon its creation to pay premiums

on a policy insuring the donor's life; such a policy may be purchased in an insurance trust to avoid estate tax thereon.

Note that, while this technique is often considered a standard option for a donor creating a charitable remainder unitrust, it works equally well with any life income gift vehicle.

VIII. Combining Non-trust Techniques

Often the planner will find that the donor's needs and desires are best met not by a single gift vehicle ("Do you want a charitable gift annuity or a conservation easement?) but by a combination of several seemingly unrelated tools. What follows is one example of this principle. Others will be discussed in the closing session of this program.

A. Charitable Home Equity Plan

With the baby boom generation lurching toward middle age, estate planners and financial planners are increasingly seeking ways to provide financial security for the elderly. Often, the major asset owned by such an individual is his/her home. Financial institutions often offer "reverse mortgages" or "reverse annuity mortgages" to permit such persons to realize on the equity built up in their homes. Under the traditional home mortgage arrangement, the lender transfers the entire amount to the borrower, who immediately begins repaying the loan in monthly installments. With a reverse mortgage, however, the loan is paid out in monthly installments over the term of the loan; at the end of the term, the entire balance, principal and interest, is due and payable. Obviously, the borrower who may have become infirm physically or financially (or both) faces a problem at this point.

Some charitable institutions are offering a comparable result by combining two standard charitable gift arrangements - the gift of a remainder interest and the charitable gift annuity.

While not a panacea, the resultant plan can be a worthwhile alternative for some donors.

Example: Assume Mrs. A, a 76-year-old widow, owns her house free of any indebtedness. She and her husband paid $50,000 for the house many years ago and it is now worth $250,000. She would like to remain in the house for the rest of her life, but cannot do so without some additional income.

Suggested Solution: Mrs. A may wish to consider retaining a life interest in her house, transferring the remainder interest in the house to charity in exchange for an annuity.

Results: Assuming the following facts, the remainder interest is worth $130,608:

Land value of $100,000, Building value of $150,000 (with salvage value of $30,000, and a useful life of 45 years)

If Mrs. A simply contributed the remainder interest to charity, she would be entitled to a charitable deduction of $130,608. Instead, however, we are assuming that she will use the remainder value to fund a charitable gift annuity.

Upon deeding a remainder interest in the property to charity, she will receive (at standard American Council on Gift Annuity recommended rates for a person her age), Mrs. A will receive quarterly annuity payments totaling $10,841 per year (i.e., 8.3% of $130,608 for the balance of her life.

Mrs. A will also be entitled to a charitable deduction of $54,103 for this transfer, which she may claim (up to 30% of her adjusted gross income) on her federal income tax return for the year of the transfer, plus a five-year carryover period.

Each annual payment of $10,841 is taxed approximately as follows:

Ordinary income	$ 4,358
Capital gain	$ 5,185
Tax-free (basis)	$ 1,298
TOTAL	$ 10,841

After Mrs. A outlives her life expectancy of 11.8 years, the annuity payments are taxed in full as ordinary income. Thus, Mrs. A receives the right to remain in the house for life, plus $10,841 per year for life and an immediate deduction of $54,103. [Note: All of the foregoing computations use a section 7520 discount rate of 5.80. Obviously, the important aspect is the underlying principle rather than the numbers.]

Potential Problem Areas: Like any possible course of action, this plan cannot be adopted blindly without careful consideration of all of the ramifications, including the following:

1. Is the charity willing (and legally able) to accept a future interest? Will this comply with any local law regulating issuance of annuities? [For example, under New York State law, real estate may not be used to fund a charitable gift annuity. Note also that the New York view is that a charity that is subject to New York law on this point for whatever reason must comply with New York law as to ALL of its annuity contracts, even those entered into with residents of other states.]

2. Where will the charity get the funds to pay the annuity, since the transferred property will not be available to finance the annuity?

3. An agreement may be necessary, providing for what happens if the property is destroyed or the donor/beneficiary must move to a nursing home or hospital, and specifying which party will pay for maintenance, taxes, insurance, expenses, and the like.

4. If the donor has a spouse or other secondary income beneficiary, the income and deduction benefits will be reduced accordingly.

5. The donor's heirs may object to the transaction. In an appropriate situation, such objections may be ameliorated by means of insurance or gifts to the heirs.

B. Other Combinations Provide Flexibility

While it is hard enough to master the various rules governing charitable transfers, the true key to their use is in learning how to use them to accomplish the aims of the donor in actual applications. The foregoing example shows how this may be accomplished in just one, very specific situation. The point is not to memorize a single application, but rather to view the various gift vehicles as specialized tools to be used thoughtfully and selectively to achieve the desired result.

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INTENTIONALLY DEFECTIVE GRANTOR TRUSTS:

Planning and Uses

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INTENTIONALLY DEFECTIVE GRANTOR TRUSTS:

Planning and Uses

I. Definition & Types of Grantor Trusts

A. Grantor Trusts are defined and discussed in IRC §671 through §678, and I refer herein to such trusts as "Grantor Trusts" or a "Grantor Trust". These code sections outline the circumstances in which a trust will be treated as owned, and thus taxed, to the grantor (or sometimes a beneficiary) of the trust rather than the trust being taxed as its own separate taxable entity. When these sections are applicable, the trust will be ignored for income tax purposes and thus be treated as a Grantor Trust.

B. These Grantor Trust rules were first enacted as a part of the 1954 Internal Revenue Code ('54 Code) to deal with the IRS's concerns over the shifting of income to taxpayers in lower tax brackets. These rules have changed little since their enactment. When these Grantor Trust rules were put in place, trusts were being used to shift taxable income either to the trust itself, where the income tax rates were once lower than individual rates, or to individual beneficiaries of such trusts that might be in lower income tax brackets. It had become a common practice to use trusts to shift income with ease to a lower bracket. The '54 Code, however, ushered in a dramatic change.

C. Even though these Grantor Trust rules have been around a long time, many tax professionals are only now beginning to fully understand all of the intricacies of these rules as a result of a tremendous increase in the number of irrevocable trusts being created. Unfortunately, many accountants are not fully informed by the drafting attorneys of irrevocable trusts as to the type of trust that was created or that is being administered. This leaves the accountant with the all-important role of determining the tax status of a particular trust.

D. Many would argue that the Grantor Trust rules of §671 through §678 are now out of date and became out of date once the trust rates went to their current flattened state. Nonetheless, whether they are out of date or not, they still remain and are an important part of the analysis required of any trust.

E. It should be noted that §671 through §678 are only applicable to income taxes and have no impact on whether the assets in a trust are includable in the grantor's estate for gift and estate tax purposes.

F. This writing will focus on irrevocable trusts being treated as Grantor Trusts. It seems that most professionals are comfortable with treating a revocable trust (i.e., a Revocable Living Trust) as a Grantor Trust. The confusion arises, however, when irrevocable trusts are treated as Grantor Trusts. It seems unnatural that an irrevocable trust that is designed to be outside the grantor's estate for gift and estate tax purposes could possibly be effectively ignored for income tax purposes under these Grantor Trust rules.

G. Having a trust be treated as "Grantor" under §671 through §678 can either be a good thing or a bad thing. For example, if there is an irrevocable trust that holds assets and is being taxed as a complex trust[1], the trust may be triggering

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[1] A complex trust, in very general terms, is a trust that does not ***require*** the annual distribution of income to the trust beneficiaries. The fact that income ***can*** be distributed is not determinative. That is, even though the income of the trust ***can*** be distributed (i.e., for health, education, support and maintenance or maybe as a solely discretionary distribution by the Trustee), this does not keep a trust from being a complex trust for income tax purposes. A complex trust will generally be taxed on the income generated

income tax at the highest levels while the grantor of such trust may be in a lower income tax bracket. In that situation, it is important to look at the terms of the trust and see if it is possibly a Grantor Trust so the income can then be taxed back to the grantor at the grantor's lower rates rather than being taxed inside the trust at the top income tax rates. Consequently, in this fact situation, having the trust treated as a Grantor Trust can be a good thing.

But a trust treated as a Grantor Trust can also be a bad thing. For example, assume that a parent sets up a trust as a simple trust[2] to pass income down to children (age 14 or older) in an attempt to have such income taxed to younger beneficiaries at their lower rates. If the trust turns out to be a Grantor Trust, then that means the income will not be taxed to the children as trust beneficiaries of a simple trust and at their lower rates, but instead will be taxed to the parent as the grantor of the Grantor Trust. Consequently, in this fact situation, having the trust treated as a Grantor Trust can be a bad thing.

H. This writer has little doubt that many trusts that are being treated as separate legal tax entities (i.e., generally a simple or complex trust) should really be taxed as Grantor Trusts. As an example, and as discussed further below, when a trust is drafted to allow the grantor to retain certain control over or possibly to benefit a spouse, then such trust may be taxed as a Grantor Trust and, consequently, the grantor or settlor of the trust may be taxed on the trust

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by the trust unless such income is distributed and then, of course, if it is distributed, the income distributed will be taxed to the distributee/beneficiary with the complex trust getting a corresponding deduction.

[2] A simple trust, in very general terms, is a trust that requires the annual distribution of income to the trust beneficiaries. In a simple trust, the income ***must*** be distributed each year to the trust beneficiaries.

activity rather than the trust being its own taxable entity. It is very easy to create a Grantor Trust, but more difficult for a trust to have non-grantor status. Many approach trusts with the assumption they are a separate taxable entity and that the Grantor Trust is the exception. The best approach is probably to assume a trust is a Grantor Trust unless it can be shown to meet the statutory tests for a non-grantor trust. The term "intentionally defective" has led both the legal and accounting professions to somehow believe that unless one "intentionally" creates a Grantor Trust, such trust will be a non-grantor trust. Such is not the case.

I. The Code uses the reference "owner" in describing an individual or someone else that is going to "own" and thus be taxed on the activity within the trust.

> "Where...the grantor or another shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual." *IRC §671*

J. It is clear that it is only §671 through §679 that trigger these rules. A grantor's retention of "dominion and control over the trust" under §61 or "any other provision" does not automatically trigger the Grantor Trust rules unless §671 through §679 specifically provide for such treatment.

> "No items of a trust shall be included in computing the taxable income and credits of the grantor or of any other person solely on the grounds of his dominion and control over the trust under section 61 (relating to definition of gross income) or any other provision of this title, except as specified in this subpart." *IRC §671*

K. The definition sections under IRC §672 are critical. It is particularly important to point out that any powers or rights that a grantor's spouse is granted under the trust will be treated as those of the grantor. The heading for IRC §672(e) is "GRANTOR TREATED AS HOLDING ***ANY*** POWER OR INTEREST OF GRANTOR'S SPOUSE", and it goes on to state as follows:

> "(1) In general--for purposes of this subpart, a grantor shall be treated as holding any power or interest held by—
>
> (A) any individual who was the spouse of the grantor at the time of the creation of such power or interest, or
> (B) any individual who became the spouse of the grantor after the creation of such power or interest, but only with respect to periods after such individual became the spouse of the grantor." *IRC §672(e) (1)*

L. The types of Grantor Trusts are best defined as follows:

1. Reversionary Interests: If the grantor [or the grantor's spouse under §672(e)] retains a reversionary interest in the trust, then the grantor is going to be treated as the owner of the assets in the trust.

> "(a) General rule--The grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value of such interest exceeds 5 percent of the value of such portion." *IRC §673 (a)*

Note: This section would not be troublesome if it weren't for the definition of "grantor" including the "grantor's spouse". Under this section, if an irrevocable trust is established to provide benefits for the grantor's spouse, that trust may be a Grantor Trust.

2. Power to Control Beneficial Enjoyment (General Rule): If the grantor [or the grantor's spouse under §672(e)] retains a power to control the beneficial enjoyment of the trust assets, the trust will be treated as a Grantor Trust.

> "The grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party." *IRC §674(a)*

This section gives the greatest guidance on what powers can and cannot be in a trust and still have the trust be non-grantor.

3. Power to Control Beneficial Enjoyment (Exceptions): Exceptions to IRC §674(a) powers and, consequently, powers that are allowed in the trust and that still allow the trust to be non-grantor are found in §674(b) and are as follows:

a) Power to apply income to support of a dependent: as a general rule, it is acceptable to have a power to support a dependant of the grantor (or the grantor's spouse) under IRC §674(b)(1); provided, however, any income actually used for such support will be treated as the income of the grantor. *IRC §677(b)*;

Note: As mentioned above, it is certainly acceptable to have provisions in the trust that will allow the trust to be used for the support of a minor child without triggering the Grantor Trust rules on the entire trust, but only to the extent that the income of the trust is used to satisfy a support obligation is such income (and only such income) subject to the Grantor Trust rules. However, it should be noted that inclusion of such a power in the grantor might trigger an IRC §2036 inclusion problem for estate and gift tax purposes.

b) Power affecting beneficial enjoyment only after occurrence of event: Simply having a power that is otherwise prohibited in the trust that is to become applicable in the future is not a problem under the Grantor Trust rules unless and until such event or condition occurs, at which time the trust would then be subject to the Grantor Trust rules. For Grantor Trust purposes, however, this gives the grantor a right to relinquish such power and avoid the Grantor Trust rules.

> "A power, the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that a grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the occurrence of the event unless the power is relinquished." *IRC §674(b)(2)*

c) Power exercisable only by will: A power to appoint income after the grantor's death does not trigger the Grantor Trust rules unless the power is a power to appoint income that has accumulated during the grantor's lifetime.

> "A power exercisable only by will, other than a power in the grantor to appoint by will the income of the trust where the income is accumulated for such disposition by the grantor or may be so accumulated in the discretion of the

> grantor or a nonadverse party, or both, without the approval or consent of any adverse party." *IRC §674(b)(3)*

Note: This type of power, however, could be a problem under IRC §2036 from an estate inclusion standpoint.

d) Power to allocate among charitable beneficiaries: Certain powers can be retained to allocate among charitable beneficiaries.

> "A power to determine the beneficial enjoyment of the corpus or the income therefrom if the corpus or income is irrevocably payable for a purpose specified in section 170(c) (relating to definition of charitable contributions) or to an employee stock ownership plan (as defined in section 4975(e)(7)) in a qualified gratuitous transfer (as defined in section 664(g)(1))." *IRC §674(b)(4)*

e) Power to distribute corpus: As long as a power to distribute corpus is limited by an ascertainable standard, such power does not trigger the Grantor Trust rules.

> "A power to distribute corpus either—
>
> (A) to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries) provided that the power is limited by a reasonably definite standard which is set forth in the trust instrument; or
>
> (B) to or for any current income beneficiary, provided that the distribution of corpus must be chargeable against the proportionate share of corpus held in trust for the payment of income to the beneficiary as if the corpus constituted a separate trust.
>
> A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children." *IRC §674(b)(5)*

f) <u>Power to withhold income temporarily:</u> This provision effectively allows for the grantor to have a discretionary power to either distribute or retain income to or for the benefit of a beneficiary. Such income, however, must be strictly allocated to such beneficiary, whether during the grantor's lifetime or after the grantor's death. That is, the grantor's power cannot result in the grantor being able to shift the income from one beneficiary to another. As long as this is only a "timing of income" issue for such beneficiary, and in no way affects whether the beneficiary will ever benefit from the income, then the power is an acceptable power that a grantor can have and not trigger the Grantor Trust rules.

> "A power to distribute or apply income to or for any current income beneficiary or to accumulate the income for him, provided that any accumulated income must ultimately be payable--
>
> (A) to the beneficiary from whom distribution or application is withheld, to his estate, or to his appointees (or persons named as alternate takers in default of appointment) provided that such beneficiary possesses a power of appointment which does not exclude from the class of possible appointees any person other than the beneficiary, his estate, his creditors, or the creditors of his estate, or
>
> (B) on termination of the trust, or in conjunction with a distribution of corpus which is augmented by such accumulated income, to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument.
>
> Accumulated income shall be considered so payable although it is provided that if any beneficiary does not

survive a date of distribution which could reasonably have been expected to occur within the beneficiary's lifetime, the share of the deceased beneficiary is to be paid to his appointees or to one or more designated alternate takers (other than the grantor or the grantor's estate) whose shares have been irrevocably specified. A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children." *IRC §674(b)(6)*

g) Power to withhold income during disability of a beneficiary:

This is a similar exception to the preceding section [IRC §674(b)(6)], but allows for a broader power as long as the beneficiary is legally disabled or under the age of 21. It should be noted, however, that if the minor (under age 21) beneficiary is also a person toward whom the Grantor has a legal support obligation, then IRC §678(c) will still be applicable to cause the income *actually distributed* to such minor to be considered Grantor Trust income and thus taxed to the grantor.

"A power exercisable only during—

(A) the existence of a legal disability of any current income beneficiary, or

(B) the period during which any income beneficiary shall be under the age of 21 years,

to distribute or apply income to or for such beneficiary or to accumulate and add the income to corpus. A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is

> to provide for after-born or after-adopted children."
> *IRC §674(b)(7)*

h) Power to allocate between corpus and income: A retention by the grantor of the power to allocate between corpus and income is not a prohibited power under the Grantor Trust rules.

> "A power to allocate receipts and disbursements as between corpus and income, even though expressed in broad language." *IRC §674(b)(8)*

4. Power to Control Beneficial Enjoyment (Independent Trustees):

Where independent trustees are utilized, the trust can grant such trustees much broader powers without running afoul of the Grantor Trust rules.

> "Subsection (a) shall not apply to a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor, and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor--
>
> (1) to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries; or
>
> (2) to pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries).
>
> A power does not fall within the powers described in this subsection if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children. For periods during which an individual is the spouse of the grantor (within the meaning of section 672(e)(2)), any reference in this subsection to the grantor shall be treated as including a reference to such individual."
> *IRC §674(c)*

5. Power to Control Beneficial Enjoyment (Ascertainable Standard):

This provision is similar to the previous provision [IRC §674(c)], where an ascertainable standard is utilized in the trust by a trustee other than the grantor (or the grantor's wife). The trust can grant such trustee a power subject to an ascertainable standard.

> "Subsection (a) shall not apply to a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor or spouse living with the grantor, to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries, whether or not the conditions of paragraph (6) or (7) of subsection (b) are satisfied, if such power is limited by a reasonably definite external standard which is set forth in the trust instrument. A power does not fall within the powers described in this subsection if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children." *IRC §674(d)*

6. <u>Administrative Powers:</u> Certain administrative powers retained by the grantor (or the grantor's spouse) can trigger the Grantor Trust rules. It is this section [i.e. IRC §675(4)(C)] that is often used to create an "intentionally defective grantor trust". That provision provides that if the grantor retains a power to "reacquire the trust corpus by substituting other property of an equivalent value" then such trust will be a Grantor Trust. *IRC §675(4)(C)*. The reason this provision commonly triggers the "intentionally defective" planning is because this language has been held to *not* create a power that causes any inclusion for estate and gift tax purposes.

Other administrative powers that will trigger the Grantor Trust rules are powers that allow the grantor 1) to deal with the trust for less than adequate and full consideration, 2) the power to borrow without adequate interest or security, or 3) to borrow (even if adequately secured) when the grantor is the trustee and such loan is not paid off by the beginning of the year following the loan.

> "The grantor shall be treated as the owner of any portion of a trust in respect of which--
>
> (1) Power To Deal For Less Than Adequate And Full Consideration
>
> A power exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party enables the grantor or any person to purchase, exchange, or otherwise deal with or dispose of the corpus or the income therefrom for less than an adequate consideration in money or money's worth.
>
> (2) Power To Borrow Without Adequate Interest Or Security
>
> A power exercisable by the grantor or a nonadverse party, or both, enables the grantor to borrow the corpus or income, directly or indirectly, without adequate interest or without adequate security except where a trustee (other than the grantor) is authorized under a general lending power to make loans to any person without regard to interest or security.
>
> (3) Borrowing Of The Trust Funds
>
> The grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year. The preceding sentence shall not apply to a loan which provides for adequate interest and adequate security, if such loan is made by a trustee other than the grantor and other than a related or subordinate trustee subservient to the grantor. For periods during which an individual is the spouse of the grantor (within the meaning of section 672(e)(2)), any reference in this paragraph to the grantor shall be treated as including a reference to such individual.
>
> (4) General Powers Of Administration
>
> A power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. For purposes of this paragraph, the

term "power of administration" means any one or more of the following powers: (A) a power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; (B) a power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; or (C) a power to reacquire the trust corpus by substituting other property of an equivalent value." *IRC §675*

7. Power to Revoke: If the grantor has a power to revest the property back to the grantor unless such power is exercisable by an adverse party.

"(a) General Rule

The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under any other provision of this part, where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a non-adverse party, or both.

(b) Power Affecting Beneficial Enjoyment Only After Occurrence Of Event

Subsection (a) shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that a grantor would not be treated as the owner under section 673 if the power were a reversionary interest. But the grantor may be treated as the owner after the occurrence of such event unless the power is relinquished." *IRC §676*

8. Income for benefit of Grantor: If the grantor has access to the income for the grantor's benefit or the grantor's spouse's benefit, including the right to use trust income for the payment of premiums on insurance that insures the life of the grantor's spouse or the grantor, then the trust will be a Grantor Trust; provided, however, such right to the income is not exercisable solely by an adverse party.

"(a) General Rule

The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be--

(1) distributed to the grantor or the grantor's spouse;

(2) held or accumulated for future distribution to the grantor or the grantor's spouse; or

(3) applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse (except policies of insurance irrevocably payable for a purpose specified in section 170(c) (relating to definition of charitable contributions)).

This subsection shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that the grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the occurrence of the event unless the power is relinquished.

(b) Obligations Of Support

Income of a trust shall not be considered taxable to the grantor under subsection (a) or any other provision of this chapter merely because such income in the discretion of another person, the trustee, or the grantor acting as trustee or co-trustee, may be applied or distributed for the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor is legally obligated to support or maintain, except to the extent that such income is so applied or distributed. In cases where the amounts so applied or distributed are paid out of corpus or out of other than income for the taxable year, such amounts shall be considered to be an amount paid or credited within the meaning of paragraph (2) of section 661(a) and shall be taxed to the grantor under section 662." *IRC §676*

9. <u>Persons other than the Grantor treated as owner:</u> The "owner" of the trust assets for income tax purposes does not have to be the grantor/settlor of the trust. In two different instances this rule can be used to shift the "grantor" status away from the original grantor to another person, usually a beneficiary of the trust.

> "(a) General Rule
>
> A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:
>
> > (1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or
> >
> > (2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject to grantor of a trust to treatment as the owner thereof.
>
> (b) Exception Where Grantor Is Taxable
>
> Subsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom section 679 applies) is otherwise treated as the owner under the provisions of this subpart other than this section.
>
> (c) Obligations Of Support
>
> Subsection (a) shall not apply to a power which enables such person, in the capacity of trustee or co-trustee, merely to apply the income of the trust to the support or maintenance of a person whom the holder of the power is obligated to support or maintain except to the extent that such income is so applied. In cases where the amounts so applied or distributed are paid out of corpus or out of other than income of the taxable year, such amounts shall be considered to be an amount paid or credited within the meaning of paragraph (2) of section 661(a) and shall be taxed to the holder of the power under section 662.

(d) Effect Of Renunciation Or Disclaimer

Subsection (a) shall not apply with respect to a power which has been renounced or disclaimed within a reasonable time after the holder of the power first became aware of its existence.

(e) Cross Reference

For provision under which beneficiary of trust is treated as owner of the portion of the trust which consists of stock in an S corporation, see section 1361(d)." *IRC* 678(a)(1).

The two triggers under §678(a)(1) and (2) are as follows:

a) If a beneficiary of a trust is granted a "Crummey" withdrawal right, then the release of such right can trigger a §678 Grantor Trust power with such "beneficiary" being treated as the owner of the trust assets. *§678(a)(1) & (2)*. Such a trust is commonly known as a "Crummey" Trust. The terms of a Crummey Trust grant to one or more beneficiaries the right to withdraw some portion or all of the gifts contributed into the trust. Generally, the withdrawal rights granted are limited to the annual exclusion available to each Crummey beneficiary (generally $11,000 for an individual gift or $22,000, if a gift is "split" with a spouse).

If the trust names only one Crummey beneficiary for the Crummey Trust and the Crummey beneficiary releases the withdrawal right, then pursuant to IRC §678 when the Crummey beneficiary releases the withdrawal right, the income tax treatment of the trust changes. Generally, the gift, and thus the right of withdrawal, is limited to a $5,000 one-time gift. This will keep the entire trust corpus as

Grantor Trust income. The IRS has on several occasions ruled[3] that the Crummey beneficiary is to be treated as the owner of the portion of trust assets that the amount of the "release" bears to the value of the assets held in the trust. Effectively, the rulings provide that upon such a release, the Crummey beneficiary is treated as the "grantor" of the released right of withdrawal for income tax purposes. The rationale is that the release of the withdrawal right is treated as if the Crummey beneficiary withdrew the gift from the trust, pursuant to the withdrawal right, and immediately re-contributed it to the trust. As a result, the income attributed to the beneficiary/grantor is a fractional share of the Trust income, the numerator of which is the value of the gifted assets and the denominator of which is all the trust assets.

The beneficiary of the trust, in addition to the Crummey power, may be given an IRC §675(4)(C) power (i.e., the power to reacquire the trust corpus by substituting other property of an equivalent value). This provision meets the test of §678(a)(2) that requires a beneficiary, after a release of a power, to be treated as the "grantor" pursuant to sections §671 through §677.

b) If a beneficiary who is not the grantor of the trust has a testamentary power to appoint the income of the trust, this also triggers the Grantor Trust rules. *§678(a)(2).* This is seen where the

[3] See PLR 8142061, PLR 8521060, and Rev. Rul. 81-6, 1981-1 C.B. 385.

grantor/settlor of a trust gives the beneficiary a power that falls within the general definition of a general power of appointment. *See, 2041(a)(2).* Note, however, that this general power is limited to the income of the trust. Further, the beneficiary's decision not to exercise his/her right to access the income through the exercise of the power of appointment (i.e., a lapse) will constitute a release of a general power of appointment. Since the general power, however, is limited to the income of the trust and not the trust corpus, the corpus is not included in the beneficiary's estate.

10. Foreign Trusts having one or more U.S. beneficiaries: As a very general overview, if a trust has a foreign trustee, then it is a foreign trust and therefore a Grantor Trust.

"(a) Transferor Treated As Owner

(1) In General--

A United States person who directly or indirectly transfers property to a foreign trust (other than a trust described in section 6048(a)(3)(B)(ii)) shall be treated as the owner for his taxable year of the portion of such trust attributable to such property if for such year there is a United States beneficiary of any portion of such trust.

(2) Exceptions--

Paragraph (1) shall not apply--

(A) Transfers by reason of death--
To any transfer by reason of the death of the transferor.

(B) Transfers At Fair Market Value--
To any transfer of property to a trust in exchange for consideration of at least the fair market value of the transferred property. For

purposes of the preceding sentence, consideration other than cash shall be taken into account at its fair market value.

(3) Certain Obligations Not Taken Into Account Under Fair Market Value Exception--

(A) In General--
In determining whether paragraph (2)(B) applies to any transfer by a person described in clause (ii) or (iii) of subparagraph (C), there shall not be taken into account--

(i) except as provided in regulations, any obligation of a person described in subparagraph (C), and

(ii) to the extent provided in regulations, any obligation which is guaranteed by a person described in subparagraph (C).

(B) Treatment Of Principal Payments On Obligation--
Principal payments by the trust on any obligation referred to in subparagraph (A) shall be taken into account on and after the date of the payment in determining the portion of the trust attributable to the property transferred.

(C) Persons Described--
The persons described in this subparagraph are--

(i) the trust,

(ii) any grantor, owner, or beneficiary of the trust, and

(iii) any person who is related (within the meaning of section 643(i)(2)(B)) to any grantor, owner, or beneficiary of the trust.

(4) Special Rules Applicable To Foreign Grantor Who Later Becomes A United States Person--

(A) In General--
If a nonresident alien individual has a residency starting date within 5 years after directly or indirectly transferring property to a foreign trust, this section and section 6048 shall be applied as if such individual transferred to such trust on the residency starting date an amount equal to the portion of such trust attributable to the property transferred by such individual to such trust in such transfer.

(B) Treatment Of Undistributed Income—

For purposes of this section, undistributed net income for periods before such individual's residency starting date shall be taken into account in determining the portion of the trust which is attributable to property transferred by such individual to such trust but shall not otherwise be taken into account.

(C) Residency Starting Date--

For purposes of this paragraph, an individual's residency starting date is the residency starting date determined under section 7701(b)(2)(A).

(5) Outbound Trust Migrations--

If--

(A) an individual who is a citizen or resident of the United States transferred property to a trust which was not a foreign trust, and

(B) such trust becomes a foreign trust while such individual is alive,

then this section and section 6048 shall be applied as if such individual transferred to such trust on the date such trust becomes a foreign trust an amount equal to the portion of such trust attributable to the property previously transferred by such individual to such trust. A rule similar to the rule of paragraph (4)(B) shall apply for purposes of this paragraph.

(b) Trusts Acquiring United States Beneficiaries--

If--

(1) subsection (a) applies to a trust for the transferor's taxable year, and

(2) subsection (a) would have applied to the trust for his immediately preceding taxable year but for the fact that for such preceding taxable year there was no United States beneficiary for any portion of the trust,

then, for purposes of this subtitle, the transferor shall be treated as having income for the taxable year (in addition to his other income for such year) equal to the undistributed net income (at the close of such immediately preceding taxable year) attributable to the portion of the trust referred to in subsection (a).

(c) Trusts Treated As Having A United States Beneficiary--

(1) In General--

For purposes of this section, a trust shall be treated as having a United States beneficiary for the taxable year unless--

(A) under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of a United States person, and

(B) if the trust were terminated at any time during the taxable year, no part of the income or corpus of such trust could be paid to or for the benefit of a United States person.

(2) Attribution Of Ownership--

For purposes of paragraph (1), an amount shall be treated as paid or accumulated to or for the benefit of a United States person if such amount is paid to or accumulated for a foreign corporation, foreign partnership, or foreign trust or estate, and--

(A) in the case of a foreign corporation, such corporation is a controlled foreign corporation (as defined in section 957(a)),

(B) in the case of a foreign partnership, a United States person is a partner of such partnership, or

(C) in the case of a foreign trust or estate, such trust or estate has a United States beneficiary (within the meaning of paragraph (1)).

(3) Certain United States Beneficiaries Disregarded--

A beneficiary shall not be treated as a United States person in applying this section with respect to any transfer of property to foreign trust if such beneficiary first became a United States person more than 5 years after the date of such transfer.

(d) Regulations--

The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section." *IRC §679*

II. Sales to Grantor Trusts

A. The Structure

1. The basic structure of a "sale to a grantor trust" is for the grantor to sell discounted assets to his or her Grantor Trust. Since the grantor is treated as the "owner" of such trust under IRC §671 through §679, the sale is ignored for income tax purposes.

2. The goal is often to move assets that have a great likelihood for appreciation out of the estate of the grantor for gift and estate tax purposes without actually "gifting" them away in a traditional irrevocable Crummey gifting trust.

3. Examples of assets often used for this planning are as follows:

a) non-voting interests in closely held companies,

b) non-voting interests in a real estate Family Limited Liability Company (FLLC) or limited partnership interests in a real estate Family Limited Partnership (FLP).

c) non-voting interests in a securities-only FLLC or FLP.

4. As mentioned above, the structure of the irrevocable trust as a Grantor Trust will allow the grantor to sell assets that he or she currently owns to the trust without triggering an income-taxable event. While the sale is recognized for gift and estate tax purposes, the sale is ignored for income tax purposes. Again, this allows for there to be a "freeze" of any or all assets that are sold to the Grantor Trust at what may be a very conservative appraisal or valuation. This technique allows for taking advantage of the significant valuation discounting opportunities that exist. All future appreciation on such asset or assets that are sold will be removed from the taxable estate for federal estate tax purposes. In a leveraged sale (discussed further below), the assets sold will be replaced with a promissory note equal to the conservative appraisal/valuation and fixed at an interest rate that today may be as low as 5%.

B. The Leveraged Sale

1. A leveraged sale to a Grantor Trust involves the Grantor Trust giving a promissory note ("Note") as part of the payment for the purchase. The Note should be secured with the assets of the trust, including a security interest in the asset just purchased.

2. Exhibit A is a chart that illustrates a Sale to a Grantor Trust plan.

3. The interest rate used on the Note should be the rate prescribed under §7872(f)(2)(A) for term notes. See Frazee v. Commissioner, 98 T.C. 554 (1992), wherein the court allowed the §7872 rate. Effectively, §7872 (f)(2)(A) authorizes the use of the "Applicable Federal Rate" under §1274(d), which divides the monthly issued rates into short-term, mid-term and long-term rates. A revenue ruling is issued each month with the new rates for that particular month. The rate for demand notes should be a floating short-term rate.

4. The interest on the Note is non-taxable interest to the grantor and is non-deductible by the Trust when accrued or paid. Since the sales transaction is between the grantor and his or her Grantor Trust, not only is the initial sales transaction ignored, but the resulting Note is also ignored. Of course for estate and gift tax purposes, the Note is not ignored and should be strictly adhered to as to all payments due thereon.

5. The sales transaction should be structured, if possible, to avoid an argument that the transaction is too thinly capitalized and thus in risk of a §2036 argument. It is best to "capitalize" the Grantor Trust initially with a gift of assets so as to give the Grantor Trust sufficient assets to then make a reasonably commercial transaction (i.e., the purchase of assets with a Note). It has been suggested that there should be a minimum of 10% capital/equity in the Grantor Trust before the sales transaction is consummated. This "10% equity test" seems to have its roots in Letter Ruling 9535026 where the IRS required the taxpayer to contribute 10% of the value of the installment purchase. The 10% equity test is not well defined and many believe that such equity is not required to defend a §2036 challenge.

6. There are several ways to secure equity in the trust. Some examples are:

a) <u>Guarantees:</u> One technique used to secure additional equity is through the use of guarantees. A beneficiary or other third party may be able to enter into a guaranty agreement as a replacement of real equity in the trust. The argument is that even thinly capitalized business entities can enter into commercial purchase transactions if the owner or someone else can provide adequate security for the transaction through personal guarantees. If guarantees are utilized, consideration should be given to a payment to the guarantor for his or her guarantee. Otherwise, there may be an argument that the guarantor has made a gift into the trust equal to the value of the guarantee.

b) Grow Equity: Start the planning a little slower, so that the first transaction of a new trust is not the "sale to the Grantor Trust" transaction. Once established, use the trust to look for leveraged purchase opportunities of new business and or real estate from third parties. For example, if the initial gift is $5,000, then contribute $5,000 into a new Limited Liability Company (LLC) and then lend to the new LLC sufficient capital to enable it to purchase the real estate or business assets. Generally, the grantor is probably going to have to guarantee the third-party loan to the LLC and, consequently, the LLC should pay the grantor for such guarantee. If the purchase of the real estate or business assets is at a bargain, then a later valuation (i.e., one year or later) might reflect sufficient equity in the new LLC to meet the 10% equity test.

c) Use of a Grantor Retained Annuity Trust (GRAT): Since a GRAT is a statutory vehicle, the equity that can build up in a GRAT can be dumped into the Grantor Trust to allow for added equity.

C. Sale of Non-Qualified Stock Options (NQSOs) to Grantor Trust

1. For clients holding NQSOs, a sale to a Grantor Trust can be considered. In doing so, however, securities regulations must be addressed.

2. While the Grantor Trust is ignored by the IRS, it will not be ignored by the SEC. However, the Grantor Trust should be able to be structured to satisfy issues that would otherwise be addressed by the SEC.

D. Grantor Trusts as S Corporation owners

1. The Grantor Trust qualifies as a shareholder of S Corporation stock under IRC §1361(c)(2). Under this section, the grantor must be the sole grantor under the Grantor Trust rules and be grantor of 100% of the income and principal of the Grantor Trust. Unlike with QSST and Electing Small Business Trusts, a Grantor Trust need not file any election to be treated as an approved S Corporation shareholder.

2. While the Grantor Trust qualifies to hold S Corporation stock, the other entities that might be created to complement the Grantor Trust planning (i.e., FLLCs and FLPs) of course do not qualify to hold the S Corporation stock. Consequently, if an FLLC or FLP is created and discounted interests are sold, the S Corporation stock must be treated as a separate sales transaction directly to the Grantor Trust.

3. Even though an S Corporation can only have one class of stock, it can have voting and non-voting stock as long as the only difference in the two classes of stock is the voting rights. IRC §1361(c)(4). Consequently, consideration should be given to recapitalizing the S Corporation to create non-voting stock so that the lower-valued non-voting stock can be sold to the Grantor Trust.

E. The "Grantor pays the tax" benefit

1. Since the Grantor Trust is effectively ignored for income tax purposes, the grantor will be paying the taxes for the income generated by the Grantor Trust. For many years, there has been continuous battle, speculation and argument over whether such payment of the tax by the grantor was effectively a "gift" to the Grantor Trust equal to the value of the taxes paid by the grantor. The further argument was that if such payment of taxes by the grantor was in fact a gift, then did such a gift in any way create a retained right that caused estate inclusion of the Grantor Trust.

2. These two issues have now been resolved. In July of this year, the IRS ruled that such tax payment by the grantor was not a gift by the grantor to the Grantor Trust, and further, that such payment by the grantor did not create any type of power causing estate inclusion. *Rev. Rul. 2004–64.*

3. The ruling stated as follows:

> *"A*'s payment of the \$2.5*x* income tax liability does not constitute a gift by *A* to Trust's beneficiaries for federal gift tax purposes because *A*, not Trust, is liable for the taxes. In contrast, in the situation presented in *Doerr v. United States*, cited above, the donor's payment was for the donee's tax liability and, as a result, the payment constituted an additional gift to the donee. In addition, no portion of Trust is includible in *A*'s gross estate for federal estate tax purposes under § 2036, because *A* has not retained the right to have trust property expended in discharge of *A*'s legal obligation." *Rev. Rul. 2004–64*

4. This creates a huge opportunity for Grantor Trust planning and for sales to Grantor Trust planning. Even if an asset that is sold is not significantly discounted at the time of the sale, with the grantor paying the taxes on such asset sold (assuming the asset sold is a pass-through entity), the estate of the grantor is going to be reduced by the payment of taxes on an asset that for estate and gift tax purposes is not in the grantor's estate. This creates a pension-fund type growth opportunity for the Grantor Trust. That is, the Grantor Trust will be set to grow without any income tax obligation, and like a pension fund, will grow at a much quicker rate. Of course, the Grantor Trust is not avoiding any income tax since the grantor pays the tax, but what it does is allow for significant appreciation opportunities that are outside the estate and gift tax reach while at the same time causing the Grantor to have a continuing reduction in his or her estate as a result of the payment of the Grantor Trust's taxes.

F. Income Tax Consequences of Termination of Grantor Trust

1. A Grantor Trust will lose its status either upon the death of the grantor (Rev. Rul 57-51), or alternatively during the lifetime of the grantor if the grantor releases or otherwise relinquishes the right or power that created the Grantor Trust status in the first place.

2. Once a Grantor Trust's status as "grantor" is terminated, the trust will then be treated as its own separate taxable entity and taxed as a simple or complex trust, depending on the terms of the trust.

3. If the termination is triggered by the grantor's death, there may be an income tax planning opportunity to trigger some postmortem tax deductions through the use of a §645 election to allow the previous Grantor Trust to then be taxed, again for income tax purposes, as part of the estate of the grantor.

G. Impact of Unpaid Note Upon Death of Grantor

1. There is an issue of whether one or more events subsequent to the original "sale to the Grantor Trust" could trigger a taxable event. The biggest of these issues is whether a taxable event occurs at the time of the death of the grantor to the extent the Note is still in existence.

2. There are two competing analyses of this issue. One argument is that under Reg §1.1001-2(c), example 5, that a taxable event will be triggered upon the Grantor Trust losing its Grantor Trust status. See Reg. §1.671-1(f), which states as follows, "For rules relating to the treatment of liabilities resulting on the sale or other disposition of encumbered trust property due to a renunciation of powers by the grantor or other owner, see Sec. 1.1001-2". Then, when we examine example 5 of Reg §1.1001-2(c), we see the following:

> *"Reg § 1.1001-2 Discharge of liabilities.*
> *1.1001-2(c) Examples.*
>
> (c) Examples. The provisions of this section may be illustrated by the following examples. In each example assume the taxpayer uses the cash receipts and disbursements method of accounting, makes a return on the basis of the calendar year, and sells or disposes of all property which is security for a given liability.
>
> **Example (5)**
>
> In 1975 C, an individual, creates T, an irrevocable trust. Due to certain powers expressly retained by C, T is a "grantor trust" for purposes of Subpart E of Part 1 of Subchapter J of the Code and therefore C is treated as the owner of the entire trust. T purchases an interest in P, a partnership. C, as owner of T, deducts the distributive share of partnership losses attributable to the partnership interest held by T. In 1978, when the adjusted basis of the partnership interest held by T is $1,200, C renounces the powers previously and expressly retained that initially resulted in T being classified as a grantor trust. Consequently, T ceases to be a grantor trust and C is no longer considered to be the owner of the trust. At the time of the renunciation all of P's liabilities are liabilities on which none of the partners have assumed any personal liability and the proportionate share of which of the interest held by T is $11,000. Since prior to the renunciation C was the owner of the entire trust, C was considered the owner of all the trust property for Federal income tax purposes, including the partnership interest. Since C was considered to be the owner of the partnership interest, C not T, was considered to be the partner in P during the time T was a "grantor trust". However, at the time C renounced the powers that gave rise to T's classification as a grantor trust, T no longer qualified as a grantor trust with the result that C was no longer considered to be the owner of the trust and trust property for Federal income tax purposes. Consequently, at that time, C is considered to have transferred ownership of the interest in P to T, now a separate taxable

> entity, independent of its grantor C. On the transfer, C's share of partnership liabilities ($11,000) is treated as money received. Accordingly, C's amount realized is $11,000 and C's gain realized is $9,800 ($11,000 - $1,200)."

3. The counter argument (that the Note is not taxable upon the termination of the Grantor Trust status) looks at an analysis of Rev. Rul. 85-13. This ruling would seem to support the analysis that there is no transfer of the underlying property to the Grantor Trust (for income tax purposes) as long as the trust is treated as a Grantor Trust since such trust is effectively non-existent for income tax purposes. The entire basis of the Grantor Trust rules under §671through §679 is that the grantor is treated as the "owner" of the trust assets. If the grantor owns them, then there has not been a transfer during his or her lifetime. If there has not been a transfer during the grantor's lifetime, a transfer triggered by the death of the grantor should not create a taxable event. It is well founded that a transfer of assets that may have a lien attached does not in and of itself trigger a taxable event. For example, in Rev. Rul. 73-183 the IRS ruled that the transfer of corporate stock upon the taxpayer's death did not constitute a disposition of the stock under §1.001(a). Consequently, there can be no gain or loss on property in the Grantor Trust at the grantor's death. The further argument is that it would not seem logical that if the debt were paid off the moment before the taxpayer's death that such payoff would not result in a taxable event, yet could somehow be taxable if not paid off at the time of the taxpayer's death.

4. As a precaution, we advise our clients to plan to repay the Note sometime after the first three or four years of the original sale, and certainly before death. Of course, an unexpected death could create a situation where this issue arises due to the Note not being paid off prior to the grantor's death. This writer believes that there is good support for the Note not triggering a tax at such event.

H. Upper Generation-Skipping Dynasty Trust

1. The use of IRC §678 to create a trust with someone other than the grantor/settlor is a significant opportunity. For purposes of the outline, the term "Dynasty Trust" will be used to describe the Upper Generation-Skipping Dynasty Trust.

2. Exhibit B is a chart that illustrates a Dynasty Trust plan. Exhibit C is a sample plan for the Dynasty Trust combined with other asset-protection planning.

3. The Dynasty Trust grants withdrawal rights to only one beneficiary (the "Crummey beneficiary"). Upon the creation of the Dynasty Trust, the settlor of the Trust will limit his or her contribution to the trust to a one-time gift, usually valued at $5,000 or less. No other gifts will be made to the Dynasty Trust.

4. In conjunction with this gift, the Crummey beneficiary will have a right to withdraw the entire gift from the trust. The settlor's gift, followed by the release by the Crummey beneficiary of his or her corresponding withdrawal right, will result in the Crummey beneficiary being deemed the Grantor for income tax purposes of 100% of all assets contributed to the trust. Accordingly, 100% of the income generated by the trust will be taxed to the grantor (in this case, the Crummey beneficiary).

5. There may be situations where an individual does not want to be taxed automatically on the Dynasty Trust income. In those situations, the settlor may direct the trustee of the trust not to invoke the Crummey withdrawal right of the Crummey beneficiary in conjunction with the one-time gift. If the Crummey right is not invoked, then the amount of the settlor's gift is not limited by the annual exclusion or the $5,000 target. Of course, the gift will not qualify for the $11,000 annual exclusion from gift tax.

6. If the Crummey withdrawal right is not invoked, the Crummey beneficiary will not be the grantor of the Dynasty Trust. Instead the Dynasty Trust will be a separate taxable entity taxed as either a simple trust or complex trust. As a complex trust, the Dynasty Trust will pay income taxes on the trust's annual income unless such income is distributed to one or more beneficiaries. Income distributed from the trust to a beneficiary is reported on Form K-1 and must be reported as income by the beneficiary on such beneficiary's annual individual income tax return.

Exhibit A

James Client
Grantor Trust planning

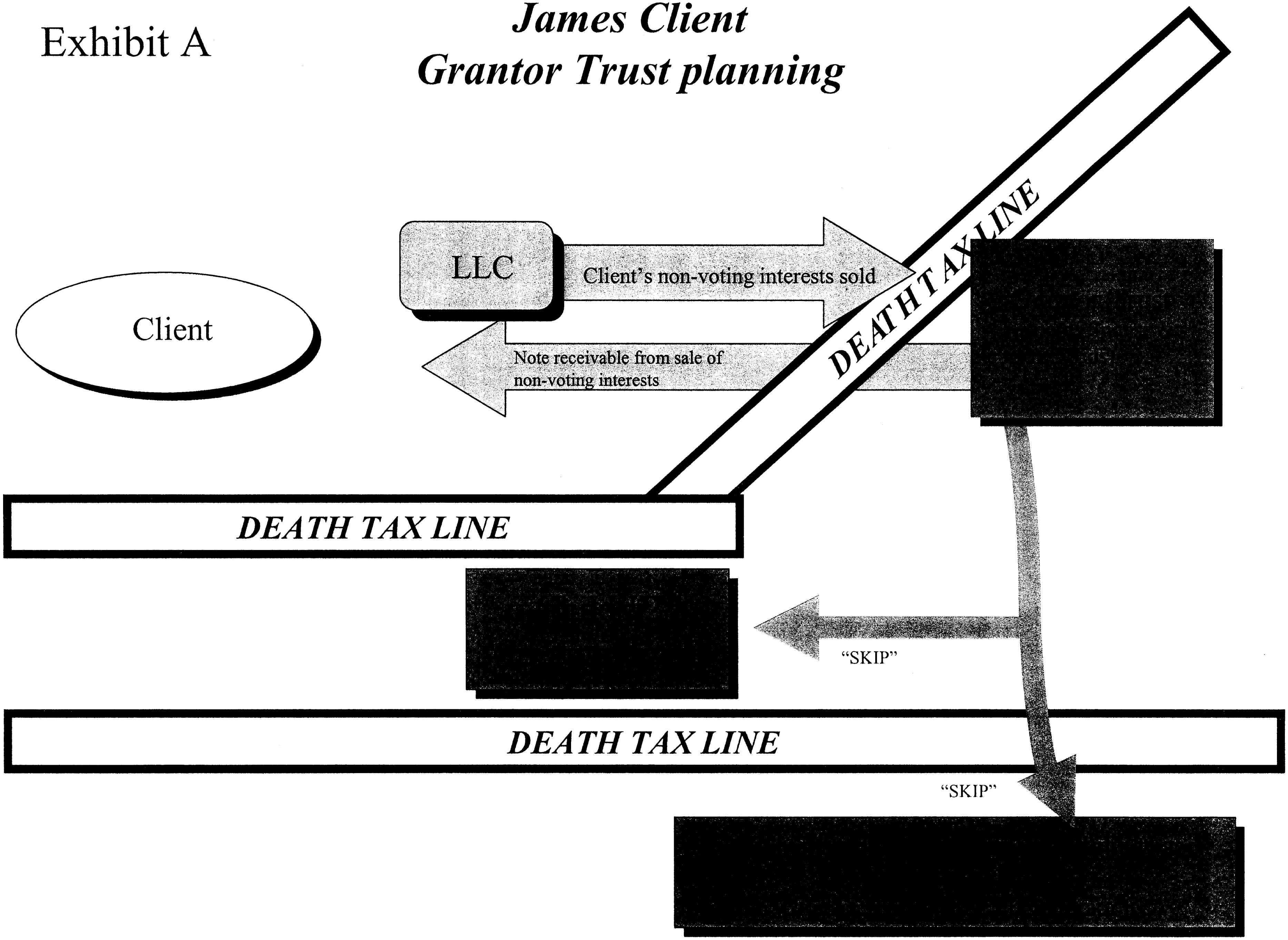

Exhibit B

James Client
Delaware Dynasty Trust planning

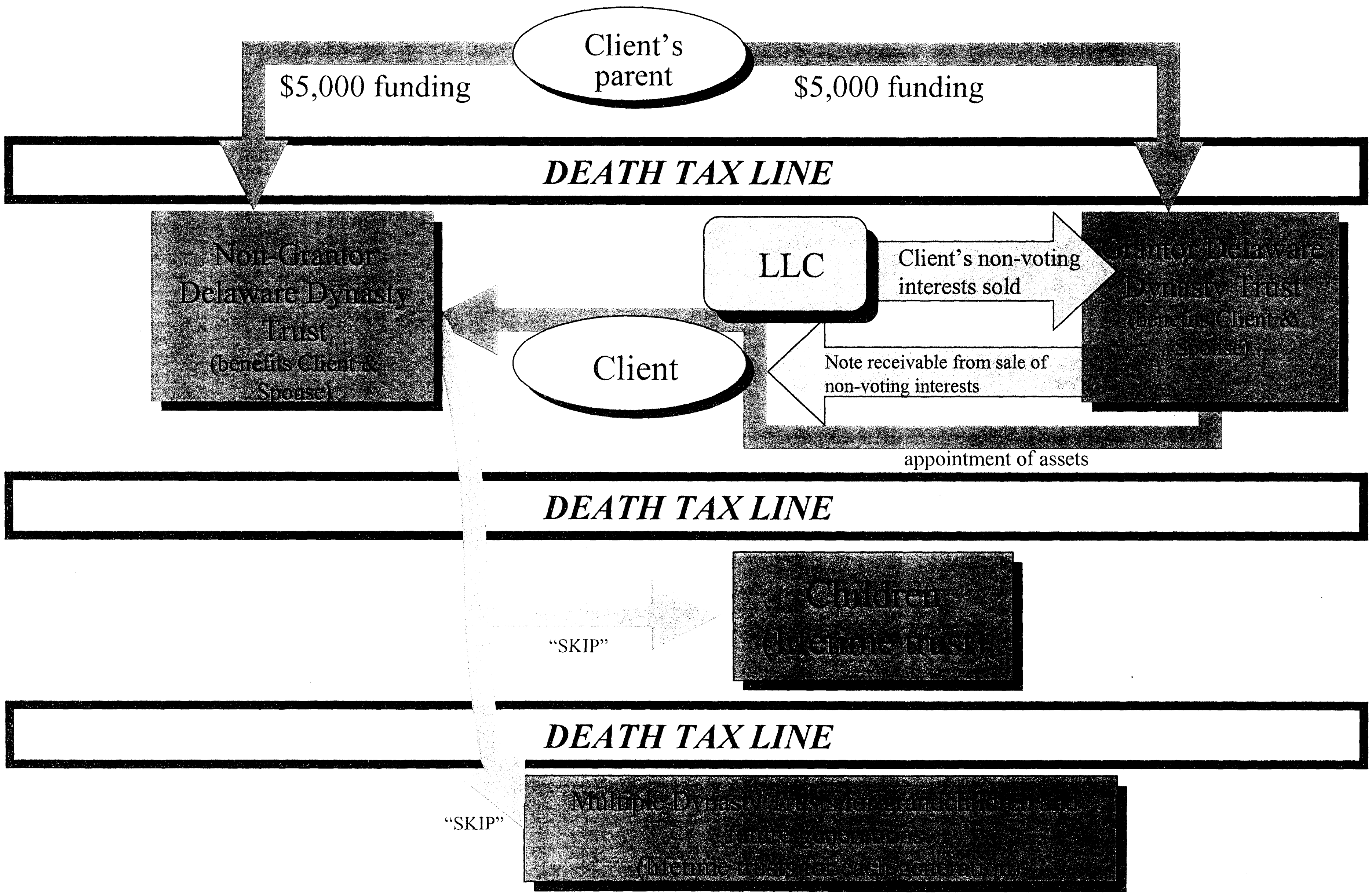

Exhibit C

BUSINESS AND TAX PLAN FOR
John Q. Client

Summary

The proposed plan is as follows:

- An Upper Generation Dynasty Trust ("Dynasty Trust") will be established by one of your parents with $5,000. The Dynasty Trust will be set up as a "Beneficiary-Grantor" Trust and possibly as a Delaware Asset Protection Trust.

- A "Backup" Dynasty Trust will be established by one of your parents with $5,000. This backup Dynasty Trust will be set up as a "non-Grantor" Trust and possibly as a Delaware Asset Protection Trust.

- A Grantor Retained Annuity Trust ("GRAT") will be established but remain unfunded.

- A Family Limited Liability Company ("FLLC") will be established to hold marketable securities and your interests in certain existing companies ("Companies").

You will fund the FLLC with interests in the Companies, stocks, bonds and cash accounts. In exchange for the funding, you will receive both voting (2%) and non-voting (98%) membership interests in the FLLC. This not only puts the principal assets in an asset-protected/favored entity, but also will allow for the removal of these assets from your taxable estate at a significant discount.

At the same time the FLLC is being established and funded, we will set up the Dynasty Trust. It will be funded by one of your parents with a one-time gift of $5,000. The trust will be designed to be treated as a "Beneficiary Grantor Trust" for income tax purposes. This will allow for sales transactions between the Dynasty Trust and you to be ignored for income tax purposes.

Once the FLLC and Dynasty Trust are established and funded, we will then proceed to have your 98% non-voting interest in the FLLC valued by an independent accounting firm. The independent valuation is expected to reflect a value for the non-voting membership units that is approximately 60% in value (i.e., 40% discount) of the assets held in the FLLHC. For example, if the assets in the FLLC are valued at $10 million, then the value of the 98% non-voting interest will only be $5,940,000 ($10,000,000 * 60% * 98%).

Exhibit C

BUSINESS AND TAX PLAN FOR
John Q. Client

There may be an opportunity to value some of your interests in the Companies at less than the value of the interests as currently carried on your financial statement. By transferring these Company interests to the FLLC, we will effectively get a second discount on such interests. With this two-tier discounting, these Company interests could be moved out of your estate at possibly 30-50 cents on the dollar of current value. Plus 100% of future appreciation (whether due to debt reduction or true asset appreciation, or both) will also be removed from your estate.

After the sale, you will own the 2% voting interests in the FLLC and will thereby control the FLLC. You will also be able to serve as the Trust Investment Advisor, giving you effective control over all investment decisions and transactions of the Dynasty Trust. The responsibilities of the corporate Delaware Trustee will be primarily administrative in nature.

The sale of the 98% non-voting interest will create a promissory note ("Note"). If we use the above $10 million example, the note will be in the approximate amount of $5,940,000.

Planning Steps

Step 1: ***Establish FLLC***

We will establish an FLLC with both voting and non-voting interests. You will transfer marketable securities and interests in the Companies to the FLLC in exchange for voting and non-voting interests. I anticipate that you will receive a 2% voting interest and a 98% non-voting interest.

Step 2: ***Value non-voting interest of the FLLC***

The FLLC non-voting interest will need to be valued prior to the sale of the FLLC non-voting interest. As a part of the FLLC valuation, each asset of the FLLC (i.e., the Companies) will need to be valued in some manner. The FLLC valuation will take into account the lack of marketability and lack of control of the interest along with other discount considerations. The discount for the FLLC non-voting interest is anticipated to range between 40% and 45%.

BUSINESS AND TAX PLAN FOR
John Q. Client

Step 3: ***Establish and Fund Upper Generation Beneficiary-Grantor Dynasty Trust(s)***

One of your parents will contribute (gift) $5,000 into the Dynasty Trust to provide for the initial funding of the Dynasty Trust.[1] Neither your parent nor anyone else will need to provide any additional funding for the Dynasty Trust beyond this initial funding.

Your parent will not retain any rights in the Trust. Assuming the Dynasty Trust is established in Delaware, the Trustee will be XYZ Bank, Delaware. You will serve as Trust Investment Advisor.

The Dynasty Trust will be established as a Beneficiary-Grantor Dynasty Trust. (See Tax Disclosures letter for a discussion of the Beneficiary-Grantor Trust.)

Upon completing Step 3:

- Dynasty Trusts established for the benefit of you, your spouse, and your issue
- Each Trust funded with $5,000 in cash

Step 4: ***Sale of non-voting interest to Dynasty Trust***

After the valuation is completed, the 98% non-voting interest in the FLLC will be sold to the Dynasty Trust. You will sell these assets to the Dynasty Trust in a non-taxable sales transaction. The sale will be non-taxable due to the Trust being a Grantor Trust for income tax purposes as to you.

Upon completing Step 4:

- The Dynasty Trust owns all of your non-voting interest in the FLLC
- The Dynasty Trust owes you an amount equal to the purchase price (less $5,000) evidenced by a Promissory Note payable to you

Step 5: ***Gift Tax Returns are filed for you and your parent***

These returns will be due by April 15, 2005, and are necessary to properly qualify the gifts into the Trusts for generation-skipping transfer tax purposes.

[1] Your parent will also establish a Non-Grantor Dynasty Trust at the same time the Beneficiary-Grantor Trust is established. This is to give you greater flexibility for income tax planning purposes. You will also establish a Grantor Retained Annuity Trust. This trust will be combined with the Dynasty Trusts to minimize any risk of there being a taxable gift for federal gift tax purposes. We can discuss these added trusts in more detail later.

Exhibit C

BUSINESS AND TAX PLAN FOR
John Q. Client

Comments:

The following are additional comments and information about the above planning:

- You will have broad access to the assets in the Dynasty Trust. Until and unless a suit is filed against you or you have some other risk of liability, you will completely control the assets and effectively have complete access to all assets for your and your family's benefit.

- Upon your death the assets can then pass (in the manner in which you may determine in the future) to your spouse, your children, and/or charitable interests. Such assets may pass to the children without any estate and gift taxation in your estate.

- Assuming the Dynasty Trust is established in Delaware, it will offer additional asset protection and the continuation of the Trust in perpetuity.

- You, as a Beneficiary of the Dynasty Trust, should not make any gifts into the Trust.

- Any transaction, such as a loan to the Trust or to an entity owned by the Trust or a sale of assets (e.g., shares of non-voting stock and/or non-voting/non-controlling LLC membership interests) at fair market value between you and the Dynasty Trust should be an arms-length transaction.

- If you do sell assets to the Dynasty Trust, such a sale <u>will be</u> recognized for federal and Kentucky *gift and estate tax* purposes, but <u>will not be</u> recognized for federal or Kentucky *income tax* purposes. The reason that such a sale is ignored for income tax purposes is due to the legal stance adopted by the IRS that a sale to the Dynasty Trust by the Beneficiary of the Trust is, in essence, a sale to the Beneficiary. In other words, because the assets held in the Dynasty Trust are treated as assets of the Beneficiary, for income tax purposes, a transaction between the Trust and the Beneficiary does not result in income or capital gains to the Beneficiary and thus, is not an income-taxable event.

- At a later time, the assets in the Dynasty Trust can be appointed to the Non-Grantor Dynasty Trust, allowing for a shift of the income tax burden from the Beneficiary to the trust. The Non-Grantor Dynasty Trust, like the Dynasty Trust, allows its assets to be held for the benefit of you and your spouse, and after the last of your and your spouse's deaths, in lifetime trusts for your children and then for your grandchildren and other future descendants.

Exhibit C

BUSINESS AND TAX PLAN FOR
John Q. Client

Timeline	
Steps	**Events**
1	Family Limited Liability Company established and securities and Company interests transferred into it
2	Company interests and non-voting FLLC interests valued
3	Beneficiary-Grantor Dynasty Trust established Non-Grantor Dynasty Trust established Grantor Retained Annuity Trust established (same day as Dynasty Trusts) Two Dynasty Trusts funded with $5,000 each Crummey letters and Release of Withdrawal Right executed (in connection with gift to Beneficiary-Grantor Dynasty Trust)
4	Sales Agreement, Note, and Security Agreement for sale of non-voting interest to Beneficiary-Grantor Dynasty Trust to be executed
5 (Apr 2005)	Gift Tax Returns filed

TO DISCLAIM OR NOT TO DISCLAIM:

EFFECTIVE USE OF DISCLAIMERS IN ESTATE PLANNING

John T. Bondurant
Frost Brown Todd LLC
Louisville, Kentucky

Douglas A. Bozell
Frost Brown Todd LLC
Louisville, Kentucky

SECTION E

TO DISCLAIM OR NOT TO DISCLAIM:

EFFECTIVE USE OF DISCLAIMERS IN ESTATE PLANNING

TO DISCLAIM OR NOT TO DISCLAIM

EFFECTIVE USE OF DISCLAIMERS IN ESTATE PLANNING

John T. Bondurant and Douglas A. Bozell
Frost Brown Todd LLC
Louisville, Kentucky

1. Purpose of disclaimers, as with other types of post-mortem estate planning, is to make adjustments in the estate after the decedent's death to overcome disadvantages (usually, but not always, tax-related) that may have resulted from one or more of the following:

(a) Inadequate pre-death estate planning;

(b) Change of circumstances of the decedent or the beneficiaries or both;

(c) Modification of the applicable law; or

(d) Circumstances surrounding the decedent's death.

2. Typical tax-oriented and non-tax related objectives of disclaimers:

(a) Increase the portion or quality of the property interests passing to the surviving spouse, in order to increase the marital deduction and thereby decrease the estate tax on the decedent's estate (see Private Letter Rulings ("PLR") 7820022, 7833008, 7937011, 7947008, 8022021, 8347001, 8443005 and 9623064; R. Goree, Jr. Estate, 68 TCM 1068 (1994));

(b) Divert the portion of the estate passing to the surviving spouse in excess of the amount conferring a tax benefit, so as to reduce or eliminate tax on the surviving spouse's estate (see PLR's 7911005, 7912049, 7913119, 7922018, 7933013, 7940062, 8012129 and 9439020);

(c) In case of successive deaths, divert the share of the second decedent in the estate of the first decedent in order to reduce estate tax on the second decedent's estate (see PLR's

7829008, 7937011 and 8015014; J. Dancy Estate v. Commissioner, 872 F.2d 84 (4th Cir.), 89-1 USTC ¶13,800);

(d) Divert property constituting income in respect of a decedent away from a single or high tax bracket beneficiary to multiple or lower tax bracket beneficiaries in order to reduce the overall income tax impact (see PLR 7830022 and 7909055);

(e) Bypass beneficiaries with substantial estates in favor of succeeding generations in order to take advantage of the decedent's available (and otherwise unused) generation – skipping transfer tax exemption and decrease the income and death taxes payable by the original beneficiaries or their estates (see PLR's 7803065, 7806080, 7933066 and 8003020);

(f) Avoid the impact of undesirable generation-skipping transfer taxes;

(g) Cure defects in a charitable remainder trust in order to qualify the trust for a charitable deduction and thereby decrease estate or gift tax (see PLR's 7809043, 7821045, 7914003, 8550018, 9347013, 9532026, 961005 and 200010019);

(h) Divert property from a beneficiary who does not want or need it to an alternate taker who does (see PLR's 7751093, 7913082, 8008078 and 8824014);

(i) Permit use of alternate valuation under Code § 2032 by having surviving spouse disclaim a portion of marital bequest sufficient enough to create a taxable estate and a small estate tax that will be reduced by alternate valuation (See Steiner, "Disclaimers – Post-Mortem Creativity," 4 Probate & Property No. 6, 43, 45 (Nov./Dec. 1990)); and

(j) Avoid reach of beneficiary's pre-existing or potential creditors (if permitted by applicable state law, such as Kentucky), but **may** not be effective in event of bankruptcy (in In Re Watson, 65 Bankr. 9 (Bankr. C.D. Ill., 1986), disclaimer was regarded as transfer within 180 days of filing of petition) and **will** not defeat a federal tax lien attaching under Code § 6321 (see Drye v. U.S., 528 U.S. 49 (1999)).

3. Effectiveness of disclaimers in Kentucky for federal tax purposes

(a) Prior to January 1, 1977 - as provided in Treas. Regs. §25.2511-1(c), in order for a disclaimer not to be treated for federal gift tax purposes as a gift from the person disclaiming to the alternate taker or takers, the disclaimer had to be (1) recognized and effective under local law; (2) made within a "reasonable time" after knowledge of the existence of the transfer; (3) made before acceptance of the property transferred; and (4) unequivocal. There was also stated in the regulation a presumption of acceptance of the property if a person failed to refuse to accept a transfer to him of ownership of the decedent's property within a "reasonable time" after learning of the existence of the transfer.

PLR 200516004 demonstrates that disclaimers of pre-1977 interests are still occurring. There a beneficiary within nine months after he attained majority disclaimed his contingent remainder interests in four pre-1977 trusts created by his great-grandparents and his grandfather, including any interest as a potential appointee of a limited power of appointment given to his grandfather by his great-grandparents.

The IRS ruled that these disclaimers were effective under Treas. Reg. § 25.2511-1(c), even though the disclaimant had received discretionary distributions from one of the trusts while he was a minor. The ruling notes that the disclaimers were valid under state law and assumes that the disclaimant had not accepted or received any benefit from the disclaimed interests.

Prior to 1974, the only provision in Kentucky relating to disclaimers was KRS 394.320, which was repealed in 1980 and which provided:

> "A devisee may disclaim by deed, acknowledged or proved, and left for record in the county clerk's office of the county in which the probate is made, within a year after notice of the probate. A copy of such disclaimer shall be filed with the clerk of the district court in which probate was made."

This provision clearly applies only to testamentary gifts. It is not clear whether it is limited to true devises (that is, gifts of interest in real estate) or applies as well to testamentary dispositions of personal property. Compare Faulkner v. Tucker, 83 S.W. 579, 26 K.L.R. 1130 (1904), with Harding's Adm'r v. Harding's Ex'r, 140 Ky. 277, 130 S.W. 1098 (1910).

In 1974 the Legislature enacted (effective June 21, 1974) the Uniform Disclaimer of Transfers by Will, Intestacy or Appointment Act (KRS 394.610 to 394.670).

Enactment of this statute considerably broadened the scope of disclaimers authorized by Kentucky law and therefore effective for federal gift tax purposes. The basic limitations of this provision are:

(1) It appears to apply only to interests created by and persons taking under testamentary instruments. It does not by its terms apply to interests created by or persons taking under inter vivos instruments, such as revocable or irrevocable inter vivos trusts.

(2) The right of disclaimer must be exercised within six months after the death of the decedent or the occurrence of the determining event (usually someone's death).

(3) The right to disclaim does not survive the death of the person having it.

The Internal Revenue Service ("the Service") would not rule whether a pre-1977 disclaimer had been made within a reasonable time (see PLR 7842103) but in view of the rather short period provided by the Kentucky statute, this presented no practical problem.

(b) Between January 1, 1977, and July 15, 1980 - In the 1976 Tax Reform Act (effective January 1, 1977) Congress enacted §2518 of the Internal Revenue Code. The Conference Committee Report on this legislation states in part:

> "Under present law, there are several estate and gift tax provisions which provide rules governing the tax consequences of an effective disclaimer. However, the provisions do not contain uniform rules on what constitutes an effective disclaimer for estate and gift tax purposes.
>
> "H.R. 14844 provides a single set of definitive rules for disclaimers for purposes of estate, gift, and generation-skipping transfer taxes. This provision generally applies to transfers creating an interest in the person disclaiming made after December 31, 1976."

Section 2518(b) sets forth the essential elements of what is defined therein as a "qualified disclaimer" as follows:

(1) It must be an irrevocable and unqualified refusal to accept an interest in property.

(2) It must be in writing.

(3) It must be received by the transferor or his legal representative or the holder of the legal title to the property involved within nine months after the later of (A) the date on which the transfer creating the interest is made or (B) the day on which the person in whom the interest is created attains age 21.

(4) The person in whom the interest disclaimed is created must not have accepted the interest or any of its benefits.

(5) As the result of the refusal or disclaimer the interest must pass without any direction by the person making the disclaimer either to the spouse of the decedent or to someone other than the person making the disclaimer.

One of the first questions which arose in the application of §2518 was whether in order for a disclaimer to be a qualified disclaimer for federal estate tax purposes it must also comply with and be authorized under the applicable state law.

The House Ways & Means Committee Report seems to make it clear that compliance with state law is <u>not</u> required, saying:

> "The bill provides definitive rules relating to disclaimers for purposes of the estate, gift and generation-skipping transfer taxes. If the requirements of the provision are satisfied, a refusal to accept property is to be given effect for Federal estate and gift tax purposes even if the applicable local law does not technically characterize the refusal as a 'disclaimer' or if the person refusing the property was considered to have been the owner of the legal title to the property before refusing acceptance of the property."

This approach would appear to be necessary to carry out Congress' intent to establish a single set of principles governing the effect of a qualified disclaimer for estate, gift and generation-skipping transfer tax purposes. Otherwise, instead of a single set of disclaimer rules there would be fifty sets, one for each state. In addition, there could be complex questions as to which state law should apply -- that of the state where the transferor lives, or where the transferee lives, or where the property is situated?

Moreover, if reference must be made to state law to determine whether a refusal is a qualified disclaimer, the result would undoubtedly be that residents of one state might be able to disclaim a particular interest or to disclaim under certain circumstances, while a resident of an adjoining state could not. Such a result is not only inequitable, but obviously is contrary to the legislative intent reflected in the above committee reports. The Service first appeared to concur. PLR 7820022 states:

> "[I]f the disclaimer is delivered to the decedent's executor within nine months from the date of the decedent's death, you will not be considered as having made a gift for federal gift tax purposes. However, we wish to emphasize that section 2518 of the Code is a federal law. Compliance with section 2518 does not necessarily mean compliance with relevant state disclaimer statutes. Accordingly, in order to insure that your disclaimer is valid for <u>state</u> law purposes, you should <u>also</u> comply with the state disclaimer-statute." (Emphasis added)

However, in PLR 7937011, the Service took a different position. There the executor of the deceased transferee attempted to disclaim her interest in the estate of the transferor. State law (Iowa) provided that a disclaimer must be filed within six months after the date of the second publication of notice to creditors, which apparently was not done, and also provided that if a disclaimant died within the time allowed for filing the disclaimer, the right to disclaim terminated. The Service ruled that while there was some authority for waiving the six months requirement, the right to disclaim under state law was terminated by the disclaimant's death. Acknowledging that Section 2518 was silent as to whether post-death disclaimers might be made by the disclaimant's personal representative, the Service concluded that if disclaimers of property were not effective under the applicable state law so as to divest ownership of the property in the disclaimant and vest it in another, the disclaimer was not a qualified disclaimer under Section 2518.

This position was confirmed in PLR 8022021, where the issue was stated as follows:

> "Where a disclaimer meets all of the requirements of sections 2045 and 2518 of the Internal Revenue Code of 1954, such as being filed within 9 months of the date of death of the decedent, may it still fail for federal tax purposes if it does not meet <u>all</u> of the respective state law disclaimer requirements?" (Emphasis added)

The state law applicable in this situation permitted the disclaimer of testamentary interests by filing the disclaimer within six months after the decedent's death or after the interest was indefeasibly fixed as to both quality and quantity. Disclaimers complying with Section 2518 were filed seven months and 18 days after the decedent's death. The Service ruled that since the beneficiaries did not file disclaimers within the period required by state law, they did not effectively divest themselves of their interests in the decedent's estate. Therefore, although the disclaimers were filed within the nine month period required by federal law, the failure of the disclaimer to divest ownership from the beneficiaries and vest it in another person under local law prevented it from being a qualified disclaimer for federal estate and gift tax purposes. The Service's position was upheld by the Tax Court in Estate of Charles Bennett, 100 T.C. 42 (1993).

(c) Beginning July 15, 1980 - On the theory that discretion is the better part of valor, it was decided that the Kentucky disclaimer statute ought to be broadened so as to coincide insofar as possible with the federal statute. Accordingly, an amendment to KRS 394.610 was drafted and submitted to provide that the right of disclaimer shall survive the death of the person having it and may be exercised by the personal representative of such person's estate, and amendments to KRS 394.620(1) and (2) were drafted and submitted to extend the filing period in each case from six to nine months. These amendments were passed and took effect on July 15, 1980.

Also taking effect on that date was a new provision (KRS 391.035), which enacted into Kentucky law the Uniform Disclaimer of Transfers under Non-Testamentary Instruments Act, with modifications identical to the amendments to KRS 394.610 and 394.620 mentioned above.

The principal consequence of this enactment was to authorize without question under Kentucky law the right to disclaim by a donee, grantee, beneficiary or surviving joint tenant under a non-testamentary instrument or contract such as a deed, inter vivos trust agreement, insurance policy or employee benefit plan.

Subsection (6) of this provision provided that it applied to a present interest in property existing on July 15, 1980, as to which the time for filing a disclaimer had not expired and to a future interest in property existing on July 15, 1980, which had not become indefeasibly vested or the taker of which had not been finally ascertained.

Under Section 2518(c) (3), enacted as a part of the Economic Recovery Tax Act of 1981, a transfer that is not effective under state law will nevertheless be treated as a qualified disclaimer for federal tax purposes if

1. The transfer is made within the time limit provided for a qualified disclaimer;

2. The transferor has not accepted the interest or any of its benefits; and

3. The transfer is made to a person (or persons) who would have received the property if the transferor had made a qualified disclaimer.

PLR's 9228004 and 9610004 illustrate both the application of § 2518(c)(3) and its trickiness. In PLR 9228004 under the decedent's will the surviving spouse received an income interest in his wife's estate, with remainder to his two sons. However, the surviving spouse's interest did not qualify for the marital deduction. Consequently, the surviving spouse and the sons entered into a written agreement not to probate the will and to allow the estate to pass by intestacy to the sons, who then disclaimed any interest therein other than a pecuniary amount. This caused the entire estate, except for the pecuniary amount, to be treated as having passed from the decedent to the surviving spouse, thus qualifying for the marital deduction. The written agreement was regarded by the Service as a qualified disclaimer by the surviving spouse under § 2518(c) (3).

In PLR 9610004, on the other hand, the Service determined that an agreement among the surviving spouse and her two children not to probate the decedent's will was not a qualified disclaimer under § 2518(c) (3). Under the will the residue of the decedent's estate was divided into a family trust and a marital trust. If the surviving spouse and both children had predeceased the decedent, the principal of the marital trust would have been added to the family trust and would have passed in equal shares to the children's descendants (the decedent's grandchildren) living at his death, none of whom filed a disclaimer or entered into the agreement not to probate the will.

The Service ruled that the agreement not to probate the will was **not** a qualified disclaimer under § 2518(c) (3), since the transferred interest did not pass to the person or persons (that is, the decedent's grandchildren) who would have received the estate in the event of a qualified disclaimer. Instead, the surviving spouse and her children were regarded as having directed the transfer of the residuary estate to the surviving spouse.

4. Disclaimer of particular types of property:

(a) Property held as joint tenants with right of survivorship:

(1) Upon the death of the other joint tenant -

(A) KRS 391.035(1) provides in part:

> "A surviving joint tenant may disclaim as a separate interest any property or interest thereon devolving to him by right of survivorship. A surviving joint tenant may disclaim the entire interest in any property, or interest therein, that is the subject of a joint tenancy devolving to him, if the joint tenancy was created by act of a deceased joint tenant, if the survivor did not join in creating the joint tenancy and he has not accepted a benefit thereunder. . . ."

(B) Under KRS 391.035(2)(a), the person entitled to disclaim must deliver the disclaimer within nine months after acquiring knowledge of its existence. The effective date of a revocable instrument or contract (such as a joint checking or savings account or investment account) is the date on which the maker no longer has power to revoke it or to transfer to himself or another the entire legal and equitable ownership of the interest. Moreover, the surviving joint tenant may not disclaim any portion of the joint account that is attributable to consideration furnished by the surviving joint tenant.

(C) Before December 31, 1997, the Treasury regulations provided that, except with respect to certain tenancies in real property created after 1976 and before 1982, a qualified disclaimer of a survivorship interest (other than a joint checking or savings account and some joint brokerage accounts) had to be made no later than nine months after the transfer that created the joint tenancy. In addition, a joint tenant could not make a qualified disclaimer of any joint interest that was attributable to consideration furnished by the disclaimant.

Several federal appellate courts held that this regulation was invalid to the extent that it required a survivorship interest in a severable joint tenancy to be disclaimed within nine months after the creation of the tenancy. Consequently, the Service promulgated Treas. Reg. § 25.2518-2(c) (4) (i), applicable to disclaimers made on or after December 31, 1997, under which a qualified disclaimer of the survivorship interest to which a surviving joint tenant succeeds by operation of law upon the death of the first joint tenant to die

(1) Must be made no later than nine months after the death of the first joint tenant (except for the special rule relating to disclaimers by persons upon attaining age 21), regardless of whether the joint interest could have been unilaterally severed under applicable state law, and

(2) Except for certain tenancies created on or after July 14, 1988, where the donee spouse is not a U.S. citizen, will be deemed to be of a one-half interest in the property, regardless of the portion attributable to consideration furnished by the disclaimant or the portion that is included in the decedent's gross estate under § 2040.

(D) The person seeking to disclaim must still comply with the requirements of Section 2518. The biggest obstacle is likely to be an assertion by the Service that the surviving joint tenant has previously accepted the interest or its benefits (see PLR's 7911005, 7912049 and 7940062). In a recent ruling (PLR 200503024), the ingenuity of the surviving spouse's attorneys enabled her to preserve the right to disclaim the survivorship interest in a joint brokerage account to which she and her husband had contributed equally, even though during the eight month period after her husband's death she had (1) directed the broker to sell certain securities in the account and buy other securities and (2) withdrawn cash from the account.

After the surviving spouse timely disclaimed her "beneficial survivorship interest" in her husband's share of the account, her attorneys directed the broker to establish and find three accounts:

(1) A tenants in common (TIC) account, held by the wife and the husband's estate as tenants in common, into which were placed assets that could not be evenly divided;

(2) An account for the wife, into which were placed (i) assets attributable to the wife's contributions to the account and (ii) assets attributable to the husband's contributions with respect to which the surviving spouse had directed purchases or sales after the husband's death; and

(3) An estate account, into which were placed assets attributable to the husband's contributions with respect to which the surviving spouse had after the husband's death made no withdrawals and directed no sales or purchases. The Service ruled that the wife's disclaimer of any interest in the estate account and of the estate's one-half share in the TIC account was a qualified disclaimer, since because the securities in the account were

severable assets, she could make a qualified disclaimer of certain securities while accepting the benefit of other securities in the account.

(2) Upon creation of the interest -- the right of disclaimer under these circumstances is presumably to be regarded in the same manner as any interest created by a non-testamentary instrument, regardless of whether the interest may be unilaterally severed under applicable state law.

(b) Interests created by a revocable inter vivos trust agreement:

(1) Prior to July 15, 1980 -- disclaimer of such interest was not specifically authorized by Kentucky law and therefore such interest probably could not be effectively disclaimed for federal tax purposes, unless the trust agreement could be regarded as a testamentary instrument within the meaning of KRS 394.610 (see PLR 7909055, which suggests that the designation of the beneficiary to receive a deceased serviceman's final pay is a testamentary instrument within the meaning of a state disclaimer statute similar to KRS 394.610).

(2) Beginning July 15, 1980 -- disclaimer of such an interest is clearly authorized by KRS 394.035. The effective date of such an instrument is usually the date of the settlor's death, when the provisions become irrevocable. Presumably this new provision of the Kentucky statute applies to interests created by revocable instruments executed prior to July 15, 1980, which did not become irrevocable until after July 15, 1980. In PLR 8003020, a revocable inter vivos trust agreement was executed July 23, 1968, and a pour-over will was executed June 25, 1971. The decedent died after December 31, 1976. The Service ruled that before the decedent's death, transfers to the trust were not subject to gift tax and no beneficiaries thereunder had any interests that required a disclaimer. The interests vested on the death of the decedent.

Accordingly, Section 2518 applied to such interests and the nine month period provided for therein commenced to run as of the date of death.

See also PLR 8008078, which quotes the House Committee Report to the effect that "a transfer is considered to be made when it is treated as a taxable transfer, i.e., a completed transfer for gift tax purposes with respect to inter vivos transfers or upon the date of decedent's death with respect to testamentary transfers." Thus, the transfer of an interest in default of the exercise of a general testamentary power of appointment is made at the death of the holder, while the transfer of an interest in default of the exercise of a limited testamentary power of appointment occurs when the power vests in the holder.

(c) Proceeds of life insurance policies and death benefits under employee benefit plans:

(1) Prior to July 15, 1980 -- not specifically authorized by Kentucky law and therefore possibly not effectively disclaimed for federal tax purposes, unless either not necessary to comply with state law or beneficiary designation is regarded as a testamentary instrument within the meaning of KRS 394.610 (see PLR 7909055, supra).

(2) Beginning July 15, 1980 -- clearly authorized by KRS 394.035. Effective date is when designation of beneficiary becomes irrevocable, such as upon death of insured or employee. In PLR 8012129, by a designation executed by the husband after December 31, 1976, the widow was to receive a survivor benefit under a qualified employee benefit plan if she survived her husband. Their children were designated as alternate beneficiaries. Neither the plan nor the funding insurance policy restricted a disclaimer by a beneficiary. The applicable state law (Florida) provided for disclaimer of interests passing to beneficiaries under insurance contracts. In ruling that the disclaimer by the widow was a qualified disclaimer under Section 2518, the

Service indicated that the widow had no interest in the plan until after her husband's death for purposes of that section.

(d) Powers of Appointment and Property Subject to Powers of Appointment.

General powers of appointment, special or limited powers of appointment, assets passing pursuant to the exercise of either a general or special power and assets passing in default of the exercise of either a general or special power are all interests in property, a disclaimer of which that complies with the requirements of § 2518 will constitute a qualified disclaimer. Several points to keep in mind are:

(1) The period (ordinarily nine months) within which the donee of a power of appointment (either general or special) may execute a qualified disclaimer of the power itself starts when the creation of the power becomes irrevocable.

(2) Since for the most part assets subject to a general power are includible in the power holder's federal estate tax gross estate (whether any such tax is due), the period within which the recipient of such assets either by the exercise, or in default of the exercise, of a general power will not start until the exercise, release or lapse of the power.

(3) Perhaps because the exercise, release or lapse of a special power is **not** a taxable event, the period within which the recipient of property either by the exercise, or in default of the exercise, of a special power begins when the creation of the power becomes irrevocable (Treas. Regs. § 25.2518-2(c)(3)(i)).

(4) The exercise to **any** extent of a power of appointment, general or special, by the donee is an acceptance of the benefits of the power, after which the donee cannot make a qualified disclaimer of the power (Treas. Regs. § 25-2518-2(d)(1)). One possible example is an attempt to "cut down" a general power of appointment to a special power of appointment.

(5) If the disclaimant of **any** interest in property (including a power of appointment) **retains** a power of appointment over the disclaimed property, the disclaimer will not be a qualified disclaimer **unless** the retained power is a power (perhaps even a non-testamentary power) the exercise of which is measured by an ascertainable standard (Treas. Regs. §§ 25.2518-2(e)(2), 25.2518-3(a)(1)(iii) and 25.2518-3(d), Ex. (9) and (10)).

5. Disclaimer of less than an entire interest:

(a) Section 2518(c) provides that a disclaimer with respect to an undivided portion of an interest which otherwise meets the requirements of Section 2518 will be treated as a qualified disclaimer of such portion of the interest.

The earlier rulings which discussed this provision did not consider whether in order for a partial disclaimer to qualify under Section 2518 it also had to be authorized by the applicable state law. For example, PLR 7849009 concludes:

> "An undivided portion of your interest, for example, may be 1/20 of your 1/5 interest in your father's marital trust or all of your interest (principal--income) in corporation X stock.
>
> "Therefore, assuming all other requirements of section 2518(b) are met, you may disclaim all or a specified undivided portion or a specific asset or assets in the marital trust and you will not be deemed as having made a gift for federal gift tax purposes."

Again, PLR 7913082 concludes:

> "Therefore, assuming all other requirements of section 2518(b) are met, you may disclaim all, or a specified undivided portion (for example 1/20 of your 1/3 interest in the trust) or all your interest (principal and income) in a specified asset or assets and you will not be deemed to have made a gift for federal gift tax purposes."

In PLR 7913119, the Service approved the disclaimer of the right to receive any of the stock of a certain corporation given by a specific provision in the will. In this ruling, the Service also approved a formula-based disclaimer of so much of the listed stocks passing under the will as were in excess of the amount necessary to enable the estate to qualify for the maximum marital deduction.

In PLR 9822014 the IRS ruled that the disclaimers by each of two trust beneficiaries of their respective interests in a portion of the trust equal to one-half of the settlor's available GST exemption were qualified disclaimers, where under the terms of the trust the amount disclaimed would pass outright to the issue of the respective disclaimant. Note that even though under the terms of the governing investment or applicable state law the effect of a disclaimer is to cause the property or interest disclaimed to pass as though the disclaimant had predeceased the transferor, this will **not** trigger the application for GST tax purposes of the so-called "predeceased parent" provisions of § 2651(e).

In PLR 7922018, the Service noted without further comment that the applicable state law permitted disclaimer of the whole or any part of a property interest before concluding:

> "[Y]ou may disclaim the entire interest bequeathed to you or a specified undivided portion of the entire interest or a specific asset or assets and you will not be deemed as having made a gift for federal gift tax purposes."

(b) In PLR 8015014, the Service was asked to rule whether the disclaimer of a designated dollar amount ($25,000) of a savings account with a balance of over $36,000 was a qualified disclaimer under Section 2518. The response was as follows:

> "Generally, a disclaimer of any interest in property which consists of less than an entire interest in the property, is <u>not</u> a qualified disclaimer within the meaning of section 2518 of the Code. However, a disclaimant shall <u>not</u> be treated as making a disclaimer of a partial interest in property if the disclaimer relates to <u>severable</u> property and the disclaimant makes a qualified disclaimer with respect to a <u>portion</u> of these items. Severable property is property which can be separated from other property to which it is joined and which, after severance, maintains a complete and independent existence. Thus, the disclaimer of $25,000 of a fund valued at $36,747.18 will be a disclaimer of severable property and valid under section 2518 of the Code." (Emphasis added)

A disclaimer of all interests in trust income or principal, etc. in excess of a specific amount is a qualified disclaimer of a pecuniary amount. See PLR 8708069.

(c) In PLR 7913119 the IRS ruled that a formula-based disclaimer in which shares of stock were disclaimed only as to the portion that would not qualify the estate for the marital deduction was a qualified disclaimer (prior to availability of the unlimited marital deduction) and the undisclaimed portion qualified for the marital deduction.

In PLR 9203028 formula disclaimers of the specific portion of a residuary estate equal to the maximum amount that could pass free of GST tax to grandchildren constituted qualified disclaimers of specific pecuniary amounts.

(d) Two "partial" disclaimers that will **not** constitute qualified disclaimers are

(1) Where the entire interest in property is received outright, the disclaimer of a remainder interest in an effort to carve out a life estate (Treas. Regs. § 25.2518-3(b)) or vice versa (Treas. Regs. § 25.2518-3(d), Ex. 2); and

(2) The disclaimer of any interest in specific assets in a trust, while retaining an interest in other trust assets, unless the assets covered by the disclaimer are removed from the trust and pass without the direction of the disclaimant to persons other than the disclaimant (unless the disclaimant is the surviving spouse of a deceased transferor) (Treas. Regs. § 25.2518-3(a)(2)).

6. What constitutes an "unqualified refusal . . . to accept an interest in property"?

In PLR 7809043, the Service ruled that the proposal of a non-charitable beneficiary to disclaim the right to income from a charitable remainder trust in return for a lump sum payment did not constitute an unqualified refusal of benefits and therefore was not a qualified disclaimer under Section 2518.

7. What constitutes an acceptance of an interest or any of its benefits?

(a) Acceptance of income benefits in trust -- in PLR 7808078 the income beneficiary of a trust established in 1948 wanted to disclaim the right to withdraw principal from the trust upon reaching age 30. The Service ruled that the earlier acceptance of income benefits from the trust precluded the disclaimer of the right to withdraw principal.

(b) Actions in a representative capacity:

(1) In PLR 7821045, the Service ruled that the actions by the beneficiary of a charitable remainder trust who was also the trustee and executrix to reform the trust provisions so that it would qualify for a charitable deduction did not constitute an acceptance of any benefits under the trust. See also PLR 8429085.

(2) In PLR 7922018, the Service ruled that the act of qualifying as independent executrix of an estate under Texas law did not constitute an acceptance of benefits conferred upon the person so qualifying either under the will or otherwise.

(3) A disclaimer by a decedent's spouse, who was also a co-executrix of his estate, of her interest in the principal of a trust was ruled to be a qualified disclaimer The exercise of her duties as a co-executrix did not constitute an acceptance of the trust property or its benefits.

(c) Actions by a joint tenant:

(1) Acceptance of the benefits of a joint tenancy after its creation precludes the subsequent disclaimer of the survivorship interest. See PLR 7911005 and 7912049.

(2) The execution of a contract for the sale of jointly owned property constituted the acceptance of the entire property interest, including the survivorship interest, thereby precluding a qualified disclaimer of such interest. PLR 7940062.

8. Whether an interest passes without any direction on the part of the person making the disclaimer:

(a) In PLR 8015014, the Service ruled that property which is disclaimed by a person in his capacity as the executor of an estate, and which, as a result of such disclaimer, passes to that person in his capacity as the beneficiary of a prior estate, nevertheless qualified as "passing to a person other than the person making the disclaimer".

(b) In PLR 7951034, the Service ruled that a disclaimer was a qualified one, even though the disclaimer directed to whom the disclaimed interest was to go, since that person would have taken the interest in the absence of such a direction. The Service did comment, however, that if this had not been the case the effort to direct the passage of the disclaimed interest, even if ineffective, might be regarded as an acceptance of the benefit of the interest.

(c) In PLR 200442027 the IRS approved a planning technique involving disclaimers that in substance appears to significantly circumvent the restrictions on the disclaimant's ability to control the disposition of the disclaimed property interests. Under the arrangement if the surviving spouse disclaims any of her interest in Trust 1, the portion disclaimed will be held in Trust 2, if the surviving spouse then disclaims any of her interest in Trust 2, the portion disclaimed will be held in Trust 3, and so forth through Trust 5.

As one might expect, each trust contained different provisions. Trust 1 was designed to terminate upon expiration of the nine-month disclaimer period and any portion that had **not** been disclaimed would be distributed outright to the surviving spouse, if she is living, or if she is not then living, to her estate. Trusts 2 and 3 appear to have been two versions of potential QTIP marital trusts and Trusts 4 and 5 two variations of a non-marital trust. The spouse planned to disclaim any interest in Trust 1 and fractional portions of Trusts 2, 3 and 4, so that the trust assets will be allocated in accordance with her "wishes" among Trust 2, 3, 4 and 5.

During this period of transition with increasing estate tax and GST tax exemptions and the possibility of ever greater exemptions or total repeal, where the surviving spouse (or her representative, such as someone to whom she has given a durable general power of attorney that specifically authorizes the making of disclaimers (see KRS 386.093(6)) can reasonably be expected to "do the right thing" this approach could provide desirable flexibility for achieving a balance between tax-related and non-tax objectives.

9. To whom does the disclaimed interest pass?

(a) The House Ways & Means Committee Report for Section 2518 states:

"If a qualified disclaimer is made, the Federal estate, gift, and generation-skipping transfer tax provisions are to apply with respect to the property interest disclaimed as if the interest had never been transferred to the person making the disclaimer."

(b) KRS 394.630 provides:

"Unless the decedent or donee of the power has otherwise provided, the property or interest disclaimed devolves as if the disclaimant had predeceased the decedent or, if the disclaimant is designated to take under a power of appointment exercised by a testamentary instrument, as if the disclaimant had predeceased the donee of the power. A future interest that takes effect in possession or enjoyment after the termination of the estate or interest disclaimed takes effect as if the disclaimant had predeceased the decedent or the donee of the power. A disclaimer relates back for all purposes to the date of the death of the decedent or the donee of the power."

(c) KRS 395.035(3) provides:

"Unless the non-testamentary instrument or contract provides for another disposition, the property or interest therein disclaimed shall devolve as if the disclaimant had died before the effective date of the instrument or contract. A disclaimer relates back for all purposes to that date. A future interest that takes effect in possession or enjoyment at or after the termination of the disclaimed interest takes effect as if the disclaimant had died before the effective date of the instrument or contract that transferred the disclaimed interest."

(d) In PLR 7833008, a decedent bequeathed his entire interest to his two daughters on the condition that they provide for their mother, his widow. In an apparent effort to vest the estate in the widow so as to qualify for the marital deduction, the daughters executed timely disclaimers of their interests in the estate. Unfortunately, each of the daughters had children living at the decedent's death, to whom the disclaimed interests passed under the anti-lapse provision in the applicable state statute.

(e) Similarly, the effect of the disclaimers described in PLR 7914003 was to cause the property disclaimed to pass to alternate takers under the decedent's will, rather than to escheat to the state, as the disclaimants evidently intended in an effort to obtain a charitable deduction.

10. By whom must the disclaimer be executed?

(a) Neither Section 2518 nor the Committee Reports talk in terms of a qualified disclaimer being made by anyone other than the person in whom the interest is created.

(b) In PLR 7947008, the decedent died intestate, leaving a wife and four adult children, each of whom had children. Each child disclaimed for himself or herself and attempted to disclaim on behalf of his or her minor children 50% of the interest he or she was entitled to receive as an heir. The Service ruled that under the applicable state law, the disclaimer on behalf of the minor children could be executed only by a guardian ad litem with probate court approval and that the attempted disclaimer by the parents on behalf of their minor children was invalid. For successful qualified disclaimers on behalf of minors, see PLR's 8701001 and 9623064 and R. Goree, Jr. Estate, supra.

(c) In PLR 8015014, the Service approved as a qualified disclaimer under Section 2518 a disclaimer by the co-executors of a deceased transferee, where the applicable state law permitted such a disclaimer. See also J. Dancy Estate, supra.

(d) KRS 394.035 and 394.610 authorize the representative of an incapacitated or protected person (such as guardian or conservator of a minor or a disabled person) to disclaim on behalf of such persons and permit a personal representative to exercise a right of disclaimer on behalf of the decedent's estate.

11. Summary

(a) In appropriate circumstances, disclaimers can be utilized to accomplish significant post-death changes in a decedent's estate plan and thereby effect substantial tax savings.

(b) The modifications and extensions of the previous Kentucky disclaimer statutes enable the beneficiaries of Kentucky decedents to obtain the maximum benefit available under the federal tax law disclaimer provisions.

12. Conclusion:

There is no better conclusion that that in BNA Tax Management #848, Disclaimers, at A-68:

> "The disclaimer is a magical device. Disclaimer permits estate planning for two estates at the best possible moment. Disclaimer permits the personal representatives and beneficiaries of a testator's estate to plan that estate *after* the testator's death. Disclaimer permits estate planning for the "second" estate, the estate of the beneficiary under the will of a testator, after the death of that testator or the estate of an intestate take after the death of the intestate decedent. Disclaimer permits estate planning when all of the possibilities are resolved and everything you want to know is known: the date of death of the decedent; the size and makeup of her estate; the age of the surviving beneficiaries, and their wealth, health and family circumstances.
>
> The disclaimer is not only a post-mortem or after-the-fact planning tool. The possibilities of the use of a disclaimer can be anticipated and planned for by the drafter of wills, trusts and durable powers of appointment.
>
> The scope of the uses of disclaimer in estate planning is limited only by the transfer tax sections of the Code and the extent of the estate planner's knowledge of these sections, other provisions of federal tax law, and relevant state law; the estate planner's ingenuity and creative thinking; and her understanding and careful application of the technical rules of the qualified disclaimer."

References

1. BNA Tax Management, Estates, Gifts, and Trusts Portfolio #848, Disclaimers (2003, Supp. 2005).

2. RIA Estate Planning & Taxation Coordinator, §§ 47,501–47,545.

3. CCH Federal Estate and Gift Tax Reports, §§ 11,339–11,419.

4. Steiner, "Disclaimers – Post-Mortem Creativity," 4 Probate & Property No. 6, 43 (Nov./Dec. 1990).

SPECIAL NEEDS PLANNING

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SECTION F

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INTRODUCTION

Parents of children with disabilities face special challenges. At first, parents are often overwhelmed with medical issues which govern whether their child will even have a future for which to plan. As medical worries may subside, families must then confront harsh economic realities. How will the child live as an adult if the child cannot work regularly or manage money? What about the parents' other children? New terms like "public assistance benefits," "Medicaid," and "disinheritance" begin to creep in the parents' vocabulary.

For many years, conventional legal wisdom required parents to disinherit their children with disabilities. This was the safest way to protect the child's eligibility for the basic public entitlement programs of Medicaid and Supplemental Security Income ("SSI") to ensure support for the child. Thus, parents often had to make the emotionally wrenching decision to disinherit the very child who seemed to need the most from them.

Legislative changes, along with development of the common law have created estate planning options other than disinheritance. Several types of trusts can now safely be drafted for a person with a disability without jeopardizing his or her eligibility for public benefits. Some options are safer than others, and families are often left weighing the desire for flexibility against the need for certainty. Estate planning attorneys need to pay particular attention to the details of the entire family situation, including the extent of the individual's disability and the need for government assistance, the government benefits available, the individual's prognosis, the age, health, availability and commitment of family caregivers, and the nature and amount of the family's and the individual's assets. A plan that might be appropriate for an severely mentally retarded adult child who is already on Medicaid in a residential care facility will be radically different from the plan for a daughter with mental illness who currently lives at home without government assistance.

I. GOALS OF SPECIAL NEEDS PLANNING

A. Assure quality of life for the individual with a disability

1. Identify a guardian/advocate
2. Make arrangement for residence, employment, social and medical care
3. Prepare a letter of intent
4. Make final arrangement

B. Preserve government benefits

1. Families planning for a child or other family member with a disability have a number of planning vehicles available to them to leave assets to benefit the disabled person without necessarily losing eligibility for need-based government programs. These include trusts which are exempt by state or federal statute (all of which have some sort of "payback" provision at the death of the beneficiary) or discretionary trusts, which may or may not be considered available, depending upon the language in the trust and the current law.

2. The goal in planning should be to come up with a flexible plan that will supplement available benefits, but is flexible enough to provide for basic care, support and maintenance if benefits disappear or are not appropriate.

C. Provide for appropriate management of available funds

D. Long term care planning for the parents.

II. QUICK OVERVIEW OF GOVERNMENT BENEFIT PROGRAMS

Many persons with disabilities depend on government benefit programs for income, health care coverage, and residential placement.

A. Some programs are available regardless of recipient's income or property.

1. **Supplemental Security Disability Income (SSDI)** pays benefits to disabled individuals who worked long enough and paid social security taxes. The amount of the monthly benefit is determined by prior work history of claimant or wage-earner under whose record claimant qualifies for benefits, but not by financial assets.

2. **Medicare** is a health insurance program for seniors that covers a portion of hospitalization, outpatient care, and a limited number of days of nursing home care when skilled nursing care or short-term rehabilitation is needed.

B. Need Based Benefit Programs, such as Supplemental Security Income (SSI) and Medicaid, have strict income and asset guidelines for eligibility.

1. **Supplemental Security Income (SSI)** provides a guaranteed income floor of $552 for a single person.

2. **Medicaid** provides medical and hospital care, prescriptions, rudimentary dental care, and residential/institutional care, and waiver programs up to $14,000/mo. In addition, a number of MR/DD Boards in Ohio will begin charging for services provided if the recipient is not Medicaid eligible.

C. Eligibility For SSI And Medicaid

1. SSI and Medicaid assist individuals who are 65 years or older; legally blind; or disabled as defined by Social Security.

2. Eligibility for both programs is based on financial need, and both **income** and **resources** of the applicant are considered.

- Income less than certain standards
- Countable resources less than $2000 for individual, $3000 for couple for SSI
- Countable resources less than $1500 for Medicaid

3. **Resources**

- A resource is property which is both **owned** by the individual, **available** to him or her, and not exempt.

- Amounts owned on the first of the month are resources, while amounts received during the month are income. "Income" retained into the next calendar month then is considered a resource. Income and resources become countable only when they are available to the recipient (or could be available upon request.) An individual has a duty to report increases in income or resources within 10 days of receipt.

- Receipt of assets from any source can impact one's eligibility for need-based programs. A monetary gift or an inheritance may be considered income and/or a resource and disqualify an individual from receiving benefits from these very important programs. The recipient cannot simply give away the excess assets, or disclaim the inheritance, as this creates a period of ineligibility for both SSI and Medicaid; the length of the period of ineligibility for SSI is dependent upon the amount of resources transferred; the length of the period of ineligibility for Medicaid is also dependent on the Medicaid benefits the recipient is receiving.

III. WHEN IS A TRUST CREATED BY A MEDICAID RECIPIENT'S PARENTS CONSIDERED AN AVAILABLE RESOURCE?

A. Trusts that meet the requirements of 42 U.S.C.§ 1396p(d)(4)(A)or (C) -- called Special Needs Trusts or Medicaid Payback Trusts and Pooled Trusts -- are not available. These trusts were carved out as the *exception* to the rule set forth in the Omnibus Budget Reconciliation Act of 1993 (OBRA '93) that self-settled trusts were deemed available. Assets in these trusts do not count for purposes of determining the assets of the beneficiary.

B. Some states also have statutory safe harbor trusts for supplemental needs that are also exempt. The Ohio Revised Code § 1339.51 permits parents to create supplemental service trusts for individuals eligible for services from ODMR/DD or ODMH. The trust must repay up to 50% of the remaining funds and the contributions are currently capped at $222,000. Trust assets can not be used for any type of support or maintenance.

C. Common law trusts with an ascertainable standard related to support are clearly an available resource for the beneficiary. Often called Support Trusts.

D. Discretionary trusts may or may not be considered available, depending on the terms of the trust and the law of the state.

IV. OBRA '93 SPECIAL NEEDS TRUSTS AND POOLED TRUSTS IN GENERAL

A. These are exempt resources for Medicaid under OBRA 93 - 42 U.S.C. § 1396p(d)(4), and for SSI under 42 U.S.C. § 1382b (e) (for trusts created on or after 1/1/2000).

B. They are generally self-settled trusts, intended to hold assets belonging to the individual with the disability. However, many states, including Ohio, allow third parties, such as the individual's parents to use these trusts.

C. Uses

1. To shelter existing assets to qualify for Medicaid and SSI - a transfer of resources to one of these trusts is not a disqualifying transfer.

2. To shelter proceeds from a settlement or judgment in a lawsuit.

3. To shelter an unplanned inheritance.

4. In divorces, to hold property settlements for a disabled spouse or child support payments in *Castle*-type cases. *Castle v. Castle*, 15 Ohio St. 3d 279 (1984).

5. Transfer of assets from an elderly parent to an exempt trust for the benefit of a disabled child in order to make the parent eligible for Medicaid[1].

D. Congress more recently clarified its intention to align the SSI eligibility rules with Medicaid's. 42 U.S.C. § 1382b(e) addresses the countability of revocable and irrevocable trusts for SSI purposes. The new law confirms that most trusts accessible to the beneficiary for basic needs are counted as a resource, but 42 U.S.C. § 1382(b)(e)(5) assures Medicaid and SSI recipients who have Special Needs Trusts that "this subsection ***shall not apply*** to a trust described in subparagraph (A) or (C) of section 1396p(d)(4) of this title." (Emphasis added.) The Social Security Administration is applying the entire subsection anyway, and finding a number of these trusts available to the beneficiary. To protect SSI eligibility it is important that the trust meet the following requirements:

1. The trust must be irrevocable.

2. The trust should have a named residual beneficiary - not be payable to the beneficiary's "heirs" or "estate" to be considered irrevocable for SS1.

3. The "payback" provision at the death of the beneficiary must make repayment to the state first priority upon the death of the beneficiary, above funeral expenses and any other debts (final taxes, trustee fees and attorney fees may be paid first.)

E. Under Ohio's revised rules, cash distributions from these trusts to the applicant/recipient are counted as unearned income. All other distributions from the trust are treated under the rules governing in-kind income. ORC 5111.151 (F)(1)(c).

V. **OBRA '93 SPECIAL NEEDS TRUSTS** (a/k/a Medicaid Payback Trusts, (d)(4)(A) trusts) O.R.C. §5111.151(F).

A. The special needs trust must be established by a:

1. Parent,
2. Grandparent,

---

[1] Or directly to the disabled child, or to non-exempt trust solely for the benefit of disabled child. *See* O.A.C. § 5101:1-39-05(A)(13).

3. Court, or
4. Legal guardian.

B. SSI policies indicate they will look at whether a parent or grandparent had legal authority to act on behalf of the individual to determine the validity of the trust. See SSA Transmittal, File No. EM 00067, May 26, 2000, paragraph D.1.e.

C. The beneficiary must be:

1. An individual under age 65 (trust remains valid after 65 but additional assets cannot be added).[3]

2. Disabled - must meet social security definition (42 U.S.C. § 1382c(3)) or corresponding definition at O.A.C. § 5101:1-39-03 or 031.

D. Terms of the Special Needs Trust

1. The trust can be revocable or irrevocable for Medicaid eligibility. If revocable, the trust should require notice to JFS upon revocation. Must be irrevocable for SSI.

2. The trustee is generally given broad discretion and broad powers.

3. The trust must be for the sole benefit of the disabled beneficiary.

4. The trust instrument should anticipate and authorize situations in which the trustee or family members may receive significant incidental benefit.

5. All Medicaid subrogation claims or prior liens must be settled before the trust is established. Federal and state case law in other states supports this position. *Sullivan v. County of Suffolk,* 174 F.3d 282, 284 (2d Cir. N.Y. 1999); *Norwest Bank, N.D., N.A. v. Doth*, 159 F.3d 328, 333 (8^{th} Cir. Minn. 1998); *Cricchio v. Pennisi,* 90 N.Y. 2d 296, 683 N.E.2d 301 (1997). Ohio has recently allowed some of these claims to be rolled over into the trust, but have requested specific language addressing the subrogation claim.

6. Must include a "payback" provision at death of beneficiary. Ensure that your payback provision is not state specific.

"Each State which has provided medical assistance to the beneficiary since the trust was established shall receive a proportionate share of the

3 If the trust contains a structured settlement, include a statement that "any periodic payments received as a part of the settlement shall not be considered additions to the Trust Estate."

assets remaining in the within Trust upon the death of the beneficiary up to an amount equal to the total medical assistance paid on his behalf by such state under a State Plan pursuant to 42 U.S.C. § 1396 *et seq*., to the extent permitted by law. The Trustee shall comply with all state and/or federal regulations in effect at the time of the beneficiary's death regarding notification and disbursement to the States."

VI. **OBRA '93 POOLED TRUSTS ((d)(4)(C) trust)** O.A.C. § 5101:1-39-271 (C)(3)(c)

A. Pooled trusts are available in Ohio through Community Fund Management Foundation (CFMF) and Fifth Third Bank of Northeastern Ohio or through the Disability Foundation in Dayton. Both require a minimum initial trust size of $5,000.

B. Pooled trusts are now available in Kentucky from the Cedar Lake Foundation for families of individuals with mental retardation and development disabilities (MR/DD). Information is available online at www.cedarlake.org.

C. In Tennessee, the Pooled Trust of Tennessee is available.

D. In Indiana, the Arc of Indiana Master Trust, can reached at (317) 259-7603.

E. The pooled trust is similar in most respects to the payback trust discussed above with the following exceptions:

1. The trust may be established by the individual with the disability,
2. There is no age limitation;
3. The pooled trust must be managed by a non-profit association;
4. A separate account is maintained for each beneficiary;
5. Individual accounts are pooled for investment and management; and
6. Funds which are <u>retained</u> by the trust at the death of the beneficiary are not subject to payback to the state. Funds transferred by parents or their third parties are not subject to payback.

F. The pooled trust is appropriate in following cases:

1. Those in which the assets are insufficient for a corporate fiduciary to handle, and in which there is no suitable individual to serve as trustee (both Ohio pooled trusts have a minimum funding requirement of only $5,000.)
2. When the beneficiary is over the age of 65.
3. If the beneficiary is competent to establish the trust, has no living parent or grandparent, and does not want to go through the court.

G. Unfortunately, pooled trusts are not available in all states to all persons with disabilities. For example, in Kentucky, the Cedar Lake Foundation limits participates to those with MR/DD.

VII. DISCRETIONARY TRUSTS (3rd Party Trusts)

A. Discretionary trusts must be established with assets belonging to someone other than the disabled beneficiary and should never include a standard for distribution that could be interpreted to include the support of the beneficiary.

B. Historically, determination of whether or not a discretionary trust was available was driven by *Bureau of Support v. Kreitzer* (1968), 16 Ohio St. 2d 147, and its progeny (including *Young v. Dept. of Human Services* (1996), 76 Ohio St. 3d 547 and *Carnahan v. Ohio Dept. of Human Services* (2000), 139 Ohio App.3d 214, 743 N.E.2d 473).

1. If the Trustee could be compelled to make payments for the support of the beneficiary, the trust was deemed available.

2. Exclusionary language that prohibited the trustee from making any payments that would have an effect on the applicant/recipient's ability to receive government assistance was disregarded by the Medicaid administrators **BUT** this language has been respected by some Ohio courts.

C. The new rules for third party trusts in Ohio are much more specific. O.R.C §5111.151(G).

> Any portion of a trust . . . is an available resource **only if** the trust permits the trustee to expend principal or corpus or assets of the trust for the applicant/recipient's medical care, care, comfort, maintenance, health, welfare, general well-being, or a combination of these purposes. The trust will still be considered an available resource even if the trust contains any of the following types of provisions:
>
> (i) Any provision that prohibits the trustee from making payments that would supplant or replace Medicaid or public assistance, or other government assistance;
>
> (ii) Any provision that prohibits the trustee from making payments that would impact or have an effect on the applicant/recipient's right or ability or opportunity, to receive medicaid, or public assistance, or other government assistance.
>
> (iii) Any provision that attempts to prevent the trust or its corpus or, principal from being counted as an available resource under this rule.

> A trust . . . that would normally be considered an available resource **shall not be counted** as an available resource under the following circumstances.
>
> (i) If the trust contains a "clear statement" requiring the trustee to preserve a portion of the trust for another beneficiary or remainderman, then that portion of the trust shall not be counted as an available resource. Terms of a trust that grant discretion to preserve a portion of the trust do not qualify as a clear statement requiring the trustee to preserve a portion of the trust.
>
> (ii) If the trust contains a "clear statement" requiring the trustee to use a portion of the trust for a purpose other than the medical care, care, comfort, maintenance, welfare, or general well-being of the applicant/recipient, then that portion of the trust shall not be counted as an available resource. Terms of a trust that grant discretion to limit the use of a portion of the trust do not qualify as a clear statement requiring the trustee to use a portion of the trust for a particular purpose.
>
> (iv) If the trust contains a "clear statement" that requires the trustee to terminate the trust if it is counted as an available resource, then it shall not be counted as an available resource. Terms of a trust that grant discretion to terminate the trust do not qualify as a clear statement requiring the trustee to terminate the trust.
>
> (v) If any person obtains a judgment from a court of competent jurisdiction that expressly prevents the trustee from using part or all of the trust for the medical care, care, comfort, maintenance, welfare, or general well-being of the applicant/recipient, then the trust or that portion subject to the court order shall not be counted as a resource.
>
> (vi) If the trust is specifically exempt from being counted as an available resource by this rule, another rule, the Ohio Revised Code, or the U.S. Code, then it shall not be counted as a resource.
>
> (vii) If the applicant/recipient presents a final judgment from a court demonstrating that he or she was unsuccessful in a civil action against the trustee to compel payments from the trust, then it shall not be counted as an available resource.

D. Drafting Pointers:

1. Dispositive language <u>must</u> be purely discretionary. Avoid all standards. Also, avoid phrases that imply a standard such as "...for the benefit of...," "...as the Trustee shall see fit...," "...as the Trustee deems appropriate for...," or "...as the Trustee may deem best for..." WATCH OUT: Ohio courts have implied standards from seemingly innocuous language. Dangerous words include: "benefit, need, desirable, require, want, care, best..."

2. Depending on the disabled person's current residential status, if you decide to limit the Trustees' discretion to providing supplemental needs only, consider using a trigger, such as the filing of an medical application, to impose the restrictions.

3. Always include an Anti Alienation Clause - Spend Thrift Clause.

> Example:
>
> The interest of any beneficiary in any Trust created hereunder shall not be subject to the claims of creditors and shall not be subject to anticipation, attachment, execution or other legal process or lien brought by or in favor of a creditor or creditors of any such beneficiary, and no alienation or assignment of any interest in this Trust shall be binding upon Trustee or anyone who may deal with Trustee. If any such beneficiary shall attempt to alienate or assign his/her interest in any Trust or the income therefrom, or if any creditor shall seek to attach it, execute against it or secure a lien thereon, the interest of such beneficiary in this Trust and the income thereof shall cease. Thereafter, Trustee shall hold the Trust until its termination hereunder.

4. Always include a Poison Pill/Explosion Clause - In Ohio, termination must be mandatory, not discretionary. But also consider giving the trustee the discretion to terminate before the mandatory termination.

> Example:
>
> If any of the principal or income of this Trust is deemed available to [Applicant] as a resource or as income for the purposes of determining his/her eligibility for, or the amount of benefits that he/she may receive from, Medicaid, SSI, MRDD or any other needs-based benefit program that he/she would otherwise be eligible for, or should the Department of Job and Family Services or the Social Security Department or any state or federal Attorney General or prosecutor try to attach or otherwise access any Trust principal or income, then this Trust shall terminate and all remaining assets shall immediately be distributed as follows: ________. The Trustee shall have authority to engage counsel to defend the Trust from such invasion.

5. Consider a clause "dumping" all Trust assets into a "safe harbor" Trust if attacked.

> Example:
>
> Furthermore, should [Applicant], his/her assignees, transferees, subrogees, creditors or anyone claiming through or on his/her behalf pursuant to a voluntary or involuntary subrogation, assignment or other transfer of his/her rights, attempt to compel a distribution from this Trust, or if the government benefits of [Applicant] under any current or future needs-based government program are affected by the existence of

> this Trust or should his/her benefits be cancelled or otherwise reduced in any manner as a result of the existence of this fund, then this separate fund shall terminate immediately and be distributed to the TRUSTEE OF THE COMMUNITY FUND MANAGEMENT FOUNDATION 1995 MASTER TRUST, currently located at 1275 Lakeside Avenue East, Cleveland, Ohio 44114-1132 to be placed in the FUNDED MASTER fund to be used for the benefit of [Applicant] under terms and conditions to be set up by the Trustee hereunder as it sees fit at that time. In such event, any residue that may remain at [Applicant]'s death shall be paid to [________________] or, if he/she is not living, then to the living issue of [_________], per stirpes.

6. Even if by regulation, no value is attributed to a statement articulating the Grantor's "intent to preserve eligibility," such language will not hurt (if the language is proper) and could help in an indirect way, such as in an action to reform the trust.

7. Add additional beneficiaries so that you can distribute income to Applicant and consider using a trusted "surrogate" - i.e. brother, sister, nephew, niece, etc. - to receive discretionary distributions of the principal. This is safer than the disinheritance option because you have creditor protection in the trust.

8. In addition to the strategies included in the new Ohio rules, consider giving the Trustees the power to amend the trust for the narrow purpose of conforming the trust to future changes in the regulations.

> Example:
>
> To amend the provisions of this Trust in any way that the Trustee determines will help achieve the Grantor's estate planning purposes or to minimize any and all state and federal gift, estate, inheritance, generation skipping and income taxes and to create a "safe harbor" for the purposes of safeguarding Grantee's eligibility for Medicaid, SSI and MRDD benefits or any similar or future "needs-based" program otherwise available to [Applicant]. Trustee may make such amendments as may be prudent in light of changes in all the laws and regulations regarding Medicaid, SSI and MRDD benefits or any needs-based government program, which may exist in the future. Any such amendment made by the Trustee in good faith shall be conclusive on all persons interested in this Trust and neither the Trustee, nor professionals employed by Trustee, shall be liable for the consequences of any amendment or non-amendment hereof.

VIII. UNIFORM TRUST CODE AND DISCRETIONARY SPECIAL NEEDS TRUSTS

A. Currently, there is a great deal of controversy about the rights of creditor's of trust beneficiaries in Sections 501 through 504 of the Uniform Trust Code as it relates to third party discretionary trusts for disabled individuals.

- Tennessee adopted its version of the UTC in April 2004. (TN Code 35-15-501 to 504)
- The Ohio Bar Association is working in conjunction with the Ohio Banker's Association on the third draft of the Ohio UTC. (This draft is available online at http://osba.ohiobar.org/docushare/dsweb/Get/ Document-19245/OUTC +Feb05+ Redlined.doc. OUTC will be located in a new title, perhaps title 58 of the Ohio Revised Code).
- Kentucky has not adopted the UTC at this time.

B. Historically, trusts were classified by categories ranging from "support trusts" on one extreme to "discretionary trusts to a subject to a standard" and "nonsupport supplemental needs trust" in the middle and "purely discretionary trusts" on the other extreme. These classifications are the source of much of the litigation about the availability of trust assets. Critics fear that the elimination of the distinction between the three different classes of discretionary trusts in UTC Section 504 will have an adverse impact on discretionary special needs trusts.

C. UTC Section 504(a) states, "whether or not a trust contains a spendthrift provision, a creditor of a beneficiary may not compel a distribution that is subject to the trustees discretion, even if: 1) the discretion is expressed in the form of a standard of distribution or 2) the trustee has abused the discretion." Section 504(b) states, "This section does not limit the right of a beneficiary to maintain a judicial proceeding against a trustee for an abuse of discretion or failure to comply wit a standard for distribution."

D. Critics of the UTC[5] are concerned that elimination of the support/discretionary distinction in the creditors' right context will bleed over into the rights and duties of beneficiaries and trustees regarding distributions, making purely discretionary trusts for disabled individual vulnerable to claims by the state that the trust assets are "available," causing ineligibility for Medicaid. They are also concerned about the UTC's good faith standard for the trustee's exercise of discretion, regardless of the use of such terms as "absolute" or "uncontrolled" in describing the trustee's discretion. There is fear that this will increase the beneficiary's ability to compel distributions, also giving the state agency that administers the Medicaid reason to count the trust as

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[5] Merric and Oshins, "Effect of the UTC on Asset Protection of Spendthrift Trusts, *Estate Planning* (Aug., Sept. and Oct. 2004); Merric and Stein, "A Threat to all SNTs," *Trusts & Estates*, Nov. 2004.

available. Finally, there is concern that the UTC permits judges to terminate special needs trusts on the basis that they are against public policy. The most recent draft of the Ohio UTC deleted this provision, but the Tennessee statute did not. TN Code 35-15-410.

E. Defender of the UTC[6] claim that the UTC will not negatively affect self-settled or third-party settled supplemental needs trusts. They claim that by adopting the rule that prohibits *creditors* from forcing trustees to exercise discretion, whether or not expressed in the form of a standard, the UTC will actually clarify and improve the creditor protection afforded by properly drafted third-party SNTs. This author worries that the defenders are missing the point -- prohibiting the creditor from reaching the trust assets is only half the battle. Medicaid administrators don't need to reach the trust assets to ruin the effectiveness of the trust. They only need to successfully claim that the *beneficiary* can reach the trust assets to deny eligibility.

F. In Ohio, the current draft substantially rewrote the creditor's rights provisions to codify the Kreitzer case by adding provisions to UTC Section 504 making it clear that the state may compel a discretionary distribution to reimburse it for care provided to a beneficiary, but only if the trust includes a support standard and does not contain a spendthrift clause. The general rule that you should always include a spendthrift provision and never include a support standard is reinforced by this position.

IX. PLANNING STRATEGIES

A. Consider "stacking" a discretionary Trust on top of a "safe harbor" trust or a simple trust for the benefit of the disabled person. In other words, the pure discretionary trust would be set up to pay income and/or principals to a "Federal Medicaid Payback Trust" (42 U.S.C. § 1396p(d)(4)(A), a "State Medicaid Payback Trust" (OHIO ANN. § 1339.51) or a simple trust that serves as a "pass through" for distributions to the disabled person. The theory here is that when the disabled person applies for Medicaid benefits, he/she is not required to disclose the pure discretionary trust because he/she is not listed as a beneficiary of that trust - he/she is only a beneficiary of the "safe harbor" trust or "pass through" trust. In addition, the larger discretionary trust can keep the exempt trust funded at a low level to minimize payback at the death of the beneficiary.

B. Build flexibility into the documents. Include language which allows the trustee to amend the trust if the rules change, and allow the trustee to pay over the trust assets to another trust which has been established for the same beneficiary.

C. In cases where the trust is irrevocable and funded, and has been found to be an available resource for a beneficiary receiving or in need of benefits, consider utilizing

6 Walsh, Davis, Kent & Newman, "What is the Status of Creditors Under the Uniform Trust Code?," *Estate Planning*, Feb. 2005.

one of the safe harbor trusts discussed above as an alternative to hold the funds. Establish a separate exempt trust and transfer the existing trust assets to the exempt trust. If the trustee has broad discretion to distribute principal, the trust assets can simply be distributed to the beneficiary, who can then transfer the assets to the exempt trust. If the trustee does not have broad discretion, a court order is generally needed.

D. Strongly consider using a combination of all the options, including partial disinheritance. You might give a part of the disabled child's share of the parent's estate to a non-disabled child to hold for the disabled child's benefit and place the remaining funds in a purely discretionary trust with multiple beneficiaries, including the disabled child's safe harbor special needs trust.

X. TAX ISSUES FOR SPECIAL NEEDS TRUSTS

A. The special needs trust requires a separate tax ID number.

B. Estate taxes - the assets in the special needs trust (after repayment to ODHS) are generally included in the beneficiary's estate under Internal Revenue Code §2036. We have incorporated credit shelter trusts in a special needs trust to minimize estate taxes upon the death of the spouse.

C. Income taxation of the trust - the special needs trust is often considered a grantor trust for income tax purposes. Rev. Rul. 83-25, 1938-1 C.B. 116, Internal Revenue Code §§ 673-677. This means that the trust's income, deductions, credits, etc. are allowable to the grantor in calculating his or her income tax. Grantor trust treatment provides more favorable tax rates.

D. If election is made to treat the trust as a complex trust, new IRS regulations allow the trust a $2,900 exemption (rather than the $100 exemption generally allowed a complex trust) if AGI **is equal or less than** $137,300 (2002). Victims of Terrorism Tax Relief Act of 2001, Section 642(b)(2)(C).

E. Distinguish between taxable income and income for Medicaid eligibility purposes

1. Hold all assets in trusts name, under trust EIN

2. Document what every expenditure is used for

XI. TRUST ADMINISTRATION

A. Even an exempt trust can cause ineligibility for Medicaid, food stamps, HUD rent subsidy and SSI if improperly administered.

B. The trustee must know which benefits the beneficiary is receiving, and clearly understand the resource and income requirements for those benefits. It is much easier to hire a corporate trustee if you delegate all decisions regarding distributions to an individual serving as the advocate for the beneficiary.

C. Trust assets should be used only to supplement benefits.

D. If the beneficiary is receiving SSI or is on Medicaid, the trust should not be used to provide food, clothing or shelter without a careful analysis, as this may constitute deemed income to the beneficiary. The rules state that ***the presumed maximum value*** (PMV) rule applies to these payments - the income attributed to the person will be a maximum of 1/3 of the SSI benefit rate plus $20 ($201.67), even if the actual amount is larger.

E. Payments should be made from the trust directly to the providers of services and goods rather than to the disabled individual.

1. No cash to beneficiary
2. No cash equivalents

F. Probate court supervision of court approved SNTs varies widely. Although the majority treat the SNT the same as a guardianship, requiring an inventory, authority to expend, bond, and accountings, some follow the requirements for testamentary trusts, requiring inventory and accountings, but no prior court approval of expenditures. Some courts do not retain continuing jurisdiction over the trust.

G. All trust records may be reviewed by the Department of Job and Family Services (DJFS) at the beneficiary's annual redetermination to ensure that expenditures have been for the benefit of the beneficiary and have been for appropriate goods or services. Good record-keeping and documentation is critical.

H. Inform the county DJFS office of plans to make major or questionable distributions. Write a letter stating what you intend to do, why it is acceptable under the regulations, and ask for a response to let you know if they agree or disagree.

F. Housing Issues - SSI released POMS SI 01120.200 F[7] in August 1999 regarding purchase of a home by a trust. This section should be considered carefully prior to

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7 POMS is available online at http//policy.ssa.gov/poms.nsf/.

purchase of a home, to determine the impact on SSI and Medicaid eligibility. The section provides:

1. If the home is held by the trust as a residence for the beneficiary, the house is not a resource to the beneficiary whether or not the beneficiary resided in the home.

2. If residing in the home owned by the trust, the beneficiary would be considered to be living in his or her own home. The beneficiary would not be considered as receiving in-kind support and maintenance (ISM), except in the month of purchase. If the trust pays a mortgage, the monthly payment of the mortgage would be considered ISM, however, to be valued at no more than the PMV.

3. If the trust pays other shelter or household operating expenses such as utilities, insurance or real estate taxes (see SI 00835.465D), these would be ISM to the beneficiary.

4. If the trust makes capital expenditures for the home, (improvements or renovations which increase the value of the home) these are not ISM.

TAX PAYMENT PROVISIONS AND EQUITABLE APPORTIONMENT

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SECTION G

TAX PAYMENT PROVISIONS AND EQUITABLE APPORTIONMENT

* Copyright 2005 Jeffrey N. Pennell (3.6) This outline originally was derived from the author's article at 22 U. Miami Inst. Est. Plan. ¶1800 (1988), and is similar to the material found in Casner & Pennell, Estate Planning §3.3 (6th ed. 1995), and were the foundation for Pennell & Danforth, Transfer Tax Payment and Apportionment, 834 Estates, Gifts, and Trusts Portfolio (Tax Mgmt. 2001). These teaching materials are intended to assist readers as a learning aid but do not constitute legal advice and, given their purpose, may omit discussion of exceptions, qualifications, or other relevant information that may affect their utility in any planning situation. Diligent effort was made to insure the accuracy of these materials but Professor Pennell assumes no responsibility for any reader's reliance on them and encourages all readers to verify all items by reviewing all original sources before applying them. The reader should consider all tax and other consequences of any planning technique discussed.

Tax Payment Provisions and Equitable Apportionment

Jeffrey N. Pennell

I. Introduction

A. Scope Of This Outline

1. This outline considers apportionment of the federal and state wealth transfer tax burden, including a discussion of:

   a. why the topic is relevant and timely,

   b. the present state of the law if an estate plan is silent regarding apportionment of the tax burden, and

   c. why and how that state law burden ought to be changed in well crafted estate plans.

2. This outline will not consider questions of how to pay the tax or when it is payable, except as those topics relate to the question of who pays and from what source.

B. Importance Of This Topic

1. When the Uniform Estate Tax Apportionment Act, 8A U.L.A. 331 (1993), was originally promulgated, two pre-eminent scholars of this topic stated:

The classic prank of out fumbling a friend for the restaurant check has a grim counterpart in the [apportionment] of state and federal death taxes . . . Many testators unwittingly [provide] for the members of their immediate family by leaving them their residuary estates. As a consequence, the burden of the unforeseen taxes often [falls] upon the . . . members nearest to the decedent.

Scoles & Stephens, *The Proposed Uniform Estate Tax Apportionment Act,* 43 Minn. L. Rev. 907 at 907 and 915 (1959).

2. As a glance at the articles listed in the Selected Bibliography shows, interest in this topic is cyclical, probably spurred by periodic tax law changes (and, perhaps, because the lessons to be learned are forgotten over the course of time). This is a planning issue that seems to get overlooked in vast numbers of plans.

3. The topic remains timely because of inattention to tax law changes.

   a. Consider the following fact situation, taken from Collier v. First Nat'l Bank, 417 S.E. 2d 653 (Ga. 1992): The decedent created a revocable inter vivos trust and, because probate in Georgia is not cumbersome and the decedent wanted certain income tax advantages that were available to probate estates but not to trusts that served as will substitutes, provided that the trust would pour back into the estate at death and be distributed from the estate to the intended remainder beneficiaries. The decedent's probate estate benefited children by a second marriage; the trust remainder went to children of a first marriage, and the trust corpus was monies inherited by the decedent from that first spouse.

(1) The problem in *Collier* arose because the decedent's will had a traditional burden on the residue tax payment provision that waived all rights of reimbursement, in a state that does not require apportionment of the tax liability. The trust corpus was includible in the decedent's gross estate and passed to the children by the first marriage under a specific bequest, leaving the residue of the decedent's probate estate to pay the taxes thereon.

(2) The children of decedent's second marriage, as residuary beneficiaries of the estate, claimed they were entitled to reimbursement for those taxes, notwithstanding the tax payment provision that purported to waive all rights of reimbursement, on the grounds that §2207B was applicable and its provisions cannot be waived without making specific reference thereto, which was lacking in this case.

(3) So what did the children of the first marriage argue? Here's a clue: the Supreme Court of Georgia "resolved" the dispute by saying:

> [T]he [parties] argue that the trust assets are includable in the decedent's gross estate . . . under different sections of the Internal Revenue Code, each with different estate tax consequences.
>
> The question of whether the transfer of these assets from the decedent . . . casts tax liability on the estate or upon the trust must be answered under the Internal Revenue Code. As such, it is beyond the jurisdiction of this court.

417 S.E.2d at 655. In other words: the Georgia Supremes don't do taxes!

(4) There appears to be no answer to the question whether inclusion of the trust assets was properly under §2033, §2036, or §2038 and, correspondingly, whether §2207B was applicable in the first instance. More importantly, §2207B was not enacted when the trust and will were drafted.

b. Another primary tax provision that generates tax payment problems is the unlimited marital deduction.

(1) It is common to avoid payment of federal (and most states') wealth transfer taxes on the death of the first spouse to die.

(2) This marital planning correspondingly shifts the tax burden to the estate of the surviving spouse, with a concomitant risk of bankrupting the spouse's estate if the source for payment of the tax is not properly specified or considered.

(3) At the same time, an increase in the incidence of second marriages requires a reappraisal of

(a) the appropriate size of a bequest to a surviving spouse if there are children by a prior marriage or if the decedent does not want to make the children wait until the survivor's death to receive all of their inheritance, and

(b) the source for payment of taxes (which inevitably will reduce the share left to either object of the client's bounty) attributable to a nonmarital disposition that exceeds the amount sheltered by the unified credit.

(4) In conjunction with postmortem planning involving the marital deduction, it is necessary to consider the source for payment of taxes caused by the

(a) surviving spouse's partial disclaimer of a marital deduction bequest, or

(b) personal representative's decision to make only a partial election under §2056(b)(7).

(5) Adoption in 1988 of §2056(d) — disallowing the marital deduction if the decedent's surviving spouse is not a United States citizen, unless a Qualified Domestic Trust is used — further illustrates the importance of tax payment planning in conjunction with marital deduction planning.

c. Adding further marital deduction related complications are the spousal annuity requirements of the Retirement Equity Act of 1984 (REA'84) under §401(a)(11).

(1) If the nonparticipant spouse does not consent and the participant dies first, with a disposition that does not conform to the spousal annuity requirements, the nonparticipant spouse makes a gift if no objection is made thereto (with potential §2036(a)(1) exposure when the spouse subsequently dies, if the nonparticipant spouse is a beneficiary of that nonconforming beneficiary designation). There may be no provision

that would permit the nonparticipant spouse to apportion taxes to the plan, there being no applicable gift tax apportionment rule to mirror the estate tax rules discussed below. As a consequence, the nonparticipant spouse may incur and must pay the tax, which may not be feasible.

(2) If the nonparticipant spouse dies first, it may be the wealth transfer tax result (but we just don't know) that the nonparticipant spouse is deemed to be the owner of a portion of the benefit, causing inclusion in the nonparticipant spouse's estate. However, notwithstanding concerns that no marital deduction is available to the nonparticipant spouse's estate (because the participant spouse may subsequently remarry and then die prior to full withdrawal of the account, in which case the spousal annuity rules may have renewed application, denying control over the benefit to the participant). Technical Advice Memorandum 8943006 held what §2056(b)(7)(C) now expressly confirms in most cases, that a nonparticipant spouse's community property interest in a qualified plan is deemed to pass to the surviving, participant spouse and to qualify for the marital deduction.

4. A further reason why tax apportionment is important is the amount and form of nonprobate property includible in determining the tax burden imposed on a typical decedent's estate.

   a. For example, repeal in 1984 of the remaining $100,000 exemption under §§2039(c) and 2039(e) has made planning for tax payment with respect to employee benefits a severe problem, particularly because many participants specify that any death benefits under the plan shall pass other than through the participant's probate estate.

   b. Another example is §2044, requiring inclusion of qualified terminable interest property in the estate of a surviving spouse, notwithstanding the spouse has no control over that property at death.

   c. An even more dramatic example is Chapter 14, which may require inclusion of property in the estate of a decedent who has no control over it at death (e.g., under the "suspense account" rules of §2701(d) or subject to §2703 because a buy-sell agreement was not effective for estate tax valuation purposes).

   d. Similarly, inclusion of assets under §§2035 through 2042 continues to raise the issue of how taxes will be paid on includible assets passing outside a decedent's probate estate. This would be exacerbated by proposals to alter §2042 and has been intensified by gaming with §2702(a)(3)(A)(ii)-authorized personal residence GRITs and other life estate and remainder interest planning.

5. In addition to traditional estate tax payment concerns, new taxes always present problems for estate planning purposes.

   a. A good example was the 1986 version of the generation-skipping transfer tax and its tax payment complexities.

   b. Introduced in Congress in 1990 was H.R. 5501, an Appreciation Estate Tax taxing capital gains at death that, if ultimately adopted, would substantially increase the tax payment problems of many estates. A carryover basis alternative would merely defer the problem, not eliminate it.

   c. Both the estimated income tax payment obligations (now imposed on all private trusts, and on estates after their second tax year) and the Alternative Minimum Tax (as now applied to fiduciary entities) will increase the income tax problems of estate administration, in addition to the traditional wealth transfer tax problems that must be considered in drafting.

6. Finally, the area is important because of the potential liability that may be visited upon a personal representative resulting from failure to consider beneficiaries of nonprobate property who may be liable for contribution to the payment of wealth transfer taxes.

   a. Liability may exist in terms of exposure to beneficiaries of the probate estate for failure to collect amounts that should have been recovered from nonprobate takers.

   b. Liability also may exist in terms of exposure to nonprobate takers for improperly failing to join them when petitioning for an order directing apportionment of the tax burden and for closing the estate without their consent, approval, or knowledge. See In re Estate of Whitaker, 538 N.E.2d 174 (Ill. App. Ct. 1989) (fiduciary personally liable for misapportioning estate tax burden). See also Estate of Rosta, 444 N.E. 2d. 704 (Ill. App. Ct. 1982) (because other nonprobate beneficiaries were represented, however, doctrine of virtual representation was deemed to apply with respect to nonprobate beneficiaries not made parties to court actions affecting apportionment of taxes); and cf. Estate of Lyons, 425 N.E.2d 19 (Ill. App. Ct. 1981) (estate beneficiaries successfully challenged personal representative's apportionment of tax burden, which was deemed improper, notwithstanding that it was based on federal estate tax values of assets received); In re Estate of Guattery, 656 N.Y.S.2d 695 (1997) (beneficiary of Totten trust account not entitled under state law to accountings but was entitled to a copy of the federal and state estate tax returns with which to audit executor's performance as it affected those trusts' estate tax liability).

7. "This is an area in which costly litigation and costly surprises are nearly always possible." Scoles, *Estate Tax Apportionment in the Multi-State Estate.* 5 U. MIAMI INST. EST. PLAN. ¶700 at 7-28 (1971).

   a. A nearly perfect illustration of this is In re Estate of Kuralt, 981 P.2d 771 (Mont. 1999), finding that the decedent left a valid holograph bequeathing property in Montana to a beneficiary about which the estate planner (indeed, the family) didn't know existed. After losing the battle over the holograph, the Wall Street firm that drafted the primary estate plan had to deal with the fallout consequences of a burden on the residue tax payment provision that wiped out the credit shelter portion of the estate and impose taxes from the Montana bequest on the marital bequest, which eroded the marital deduction and generated more tax that also was paid from the marital bequest and further generated taxes in a circular whirlpool calculation, all without apportionment, according to the final chapter in 68 P.3d 662 (Mont. 2003).

   b. In another case it might be an insurance policy payable to comply with some unrevealed promise or obligation (such as to support a nonmarital child or part of a business deal), property discovered in a safety deposit box with a handwritten note constituting a valid disposition to (or confirming a joint tenancy with) a third party, or an asset transferred inter vivos and includible in the gross estate, all in ways that increase the gross estate for tax purposes but, because of the beneficiary, cannot qualify for the marital deduction. The point is that there are significant unexpected consequences of placing the burden of tax payment on the residue of an estate without knowing all the facts (indeed, without *ever* being able to know *all* the facts).

II Summary of Rules Regarding Payment

A. Primary obligation to pay.

1. The initial obligation to pay the entire federal estate tax imposed on a decedent's gross estate (whether probate or nonprobate property) rests on the decedent's personal representative, regardless of the fact that certain assets constituting the gross estate for federal estate tax purposes may not be in the possession or control of that fiduciary.

2. Under §2002, "[t]the tax imposed by this chapter shall be paid by the executor," and §2203 defines "executor" to mean "the executor or administrator of the decedent . . . ."

3. So extensive is this primary obligation that, if any portion of the tax is paid by the recipient of nonprobate property included in the gross estate, that payor is entitled to reimbursement from the personal representative.

a. A recipient other than the personal representative might be compelled to pay a portion of the estate tax, equal to the value of property actually received by that person, if the estate tax otherwise is not paid when due (as discussed below).

b. Under §2205:

If the tax or any part thereof is paid by, or collected out of, that part of the estate passing to or in the possession of any person other than the executor in his capacity as such, such person shall be entitled to reimbursement out of any part of the estate still undistributed or by a just and equitable contribution by the persons whose interest in the estate of the decedent would have been reduced if the tax had been paid before the distribution of the estate or whose interest is subject to equal or prior liability for the payment of taxes, debts or other charges against the estate, *it being the purpose and intent of this chapter that so far as is practicable and unless otherwise directed by the Will of the decedent the tax shall be paid out of the estate before its distribution.* (Emphasis added)

c. By virtue of the definition of "executor" in §2203, only "if there is no executor or administrator appointed, qualified, and acting [does] any [other] person in actual or constructive possession of any property of the decedent" become initially liable for payment of the tax. Thus, the person paying the tax is given the right to reimbursement from the personal representative.

4. Time of Payment. It is not the purpose of this outline to discuss the time for payment of taxes. Nevertheless, the time of payment is important to the question of who must pay the tax because, if the tax is not paid when due, liability for payment of the tax may extend to each transferee or holder of property included in the gross estate, with personal transferee liability attaching to the extent of the lesser of the total tax that is due or the value of the property received or held by the transferee. Thus:

a. Payment of the tax is due at the time the return is required to be filed, unless an extension of the time for payment is secured (note that an extension of the time for filing the return does not constitute an extension of the time for payment of the tax). Treas. Reg. §20.6151-1(a).

b. If the personal representative does not pay the tax when due, §2002 imposes personal liability on that fiduciary for the amount of the tax, effected through a lien under §6321 (based on 31 U.S.C. §192, which imposes personal liability on anyone who distributes estate property prior to satisfaction of all indebtedness to the United States). See Hochberg & Silbergleit, *Recent cases narrow scope of executor's personal liability for estate taxes,* 7 EST. PLAN. 2 (1980); Casey, FEDERAL TAX PRACTICE §§12.51 – 12.63 (rev. ed. 1977); and Annot., *Construction and Effect of 31 USC section 192 Imposing Personal Liability on Fiduciary For Paying Debts Due by Person or Estate For Whom He Acts Before Paying Debts Due the United States,* 41 A.L.R.2d 446 (1955).

c. Transferee liability is thus *in addition to* the liability that normally attaches to the personal representative and is dictated by §§6324(a)(2) (lien) and 6901(a)(1) and (h) (transferee liability); in addition, the lien attaches to any proceeds from the sale of assets included in the estate, under §6324(a)(2) and Treas. Reg. §301.6324-1(a)(2)(iii).

d. In either case, personal liability is discharged under §2204(a) (discharge of personal representative), 2204(b) (discharge of fiduciary other than personal representative), or 6325(c) (discharge of transferee liability) once the tax is paid (or payment is adequately secured).

5. Several extensions of time may defer liability for estate tax payment:

a. Under §6161(a)(2), an extension of up to 10 years may be granted in the discretion of the Secretary for "reasonable cause," and of up to 12 additional months for any installment under §6166.

b. Qualifying under Treas. Reg. §1.6161-1(a)(1) *Examples 1-4* as "reasonable cause" for deferral would be:

(1) an inability to marshall liquid assets because they are located in other jurisdictions or because litigation is required to collect them;

(2) an inability to borrow on better than disfavorable terms (in relation to returns otherwise available to the estate on its investments); and

(3) an insufficiency of funds to maintain the decedent's family, pay claims against the estate, and pay the estate tax, coupled with an inability to borrow at prevailing market rates.

c. In addition, the Code contains two automatic extensions of the time for payment:

(1) Section 6163 permits extension of that portion of the estate tax attributable to inclusion in a decedent's gross estate of either a reversion or a remainder.

(a) Under this extension provision, the tax need not be paid until six months after termination of all preceding interests in the property, and for reasonable cause may be extended for an added three years, presumably under the same standards applied for extensions for reasonable cause under §6161. See Joint Comm. on Tax'n, General Explanation of the Tax Reform Act of 1976, H.R. Rep. No. 1380, 94th Cong., 2d Sess. 546, reprinted at 1976-2 C.B. 558.

(b) Apparently this extension is not available for taxes attributable to an executory interest (e.g., "to A, but if (s)he remarries, to B;" B's interest is a shifting executory interest).

i) Presumably, this is because the shifting executory interest may never become possessory.

ii) If deferral were permitted until termination of all preceding interests, the tax payment obligation could be extinguished entirely.

iii) Thus, it makes sense that §6163 does not apply to such an interest.

(c) Once the tax *is* payable, questions of apportionment to the subject property may arise, long after death of the subject decedent and with §2015 credit allocation issues that may need resolution.

(2) The second automatic extension of time for payment is that granted under §6166 for the portion of tax attributable to inclusion of the value of a closely held business in decedent's gross estate, permitting payment in as many as ten equal annual installments, with the first required no sooner than five years after the time otherwise specified for payment.

(a) Section 6166 is a lengthy subject in its own right, well beyond the purview of this outline and adequately covered in other excellent materials.

(b) See, e.g., Metz v. United states, 91-1 U.S. Tax Cas. (CCH) ¶60,071 (10th Cir. 1991) (recipient of property pursuant to personal-services contract incurred transferee liability when estate was unable to service its §6166 installment payments on corporate stock also included in the decedent's estate).

d. Problematical about all these deferrals is that each requires the taxpayer to pay interest on the taxes deferred; interest is computed under §6621 at the same rate as that charged on any underpayment, with the exception of any tax deferred under §6166 on the first $1.1 million (inflation indexed) of includible property in excess of the applicable exclusion amount sheltered by the unified credit. See §§6601(a), (b)(1), 6166(f), and Treas. Reg. §§20.6161-1(c)(2), 20.6161-2(e), 20.6163-1(d), and 20.6166-1(f). With respect to §6166 deferral, §6601(j)(1)(A) gives a special 2% rate of interest for the tax on that first $1.1 million of includible value and §6601(j)(1)(B) reduces the interest on the balance of the deferred tax to 45% of the otherwise applicable rate on any balance exceeding that 2% portion.

e. While personal liability of the fiduciary for payment of the deferred tax otherwise is mandated under §6321, it may be supplanted by the posting of a bond under §§2204 and 6165.

(1) Often, however, the requirements for the bond are so onerous that this alternative seems unattractive.

(2) See Treas. Reg. §§20.2204-1(b) and 20.6165-1(a), calling for bonds not in excess of twice the tax deferred, and §§2204(c) and 6324A, which provide for a lien with respect to taxes payable in installments under §6166.

(3) Thus, the personal representative may have continuing significant liability if deferral is selected, making this a troubling prospect for many estates.

B. Apportionment options.

1. Section 2205 represents Congressional policy that the estate tax should be a burden on the estate as a whole, not on the individual beneficiaries of the estate as is the case with most state wealth transfer taxes.

a. Riggs v. Del Drago, 317 U.S. 95 (1942), held that state law or the terms of the decedent's estate plan may alter this apportionment of the federal estate tax in any manner.

b. Thus, the tax burden may be apportioned, so that the effect of credits, deductions, and inclusion of assets affects or benefits those beneficiaries who receive assets, generate credits or deductions, and so forth.

2. With this freedom to apportion, up to six major apportionment decisions must be made, several with additional subissues that may be addressed under state law.

a. Inside Apportionment deals with the question whether taxes ought to be borne by all classes of dispositions within (inside) a probate estate.

(1) The firmly established common law rule is that taxes in the probate estate are a "burden on the residue," meaning that all taxes are paid out of the residuary estate before any taxes are allocated to or payable from other dispositions, such as general, demonstrative, or specific dispositions under a will. See, generally, Annot., *Ultimate Burden of Estate Tax in Absence of Statute, Will or Other Provision*, 68 A.L.R.3d 714 (1976).

(2) To the extent inside apportionment is dictated, every taker under a will bears a proportionate share of the taxes payable, regardless of the

priority or class of disposition involved, and regardless of whether the subject property is realty or personalty.

(3) At one time the common law distinguished between personalty and realty within any class of disposition, favoring the realty by specifying that the personalty should be used first to pay debts, expenses, and taxes. Thus, for example, even in a burden on the residue apportionment, the takers of residuary personalty would be disappointed prior to the takers of residuary realty. This antiquated system appears to have been rejected everywhere, notwithstanding that it was consistent with the common law abatement rules that favored realty.

(4) This rule was consistent with the common law abatement rules that favored realty and called for diminution of the residue before using property earmarked for general dispositions and before exhausting assets specifically bequeathed or devised.

b. Outside Apportionment. Outside apportionment stands in juxtaposition to inside apportionment in testate and intestate estates alike, involving the issue whether taxes on the total taxable estate for federal estate tax purposes ought to be apportioned among the takers of probate assets (either with or without inside apportionment) and the recipients of includible nonprobate assets.

(1) Thus, if property is includible in the gross estate of a decedent under any of the following sections, outside apportionment would dictate that the recipient of the property pay that portion of the taxes imposed on the total estate attributable to that inclusion (computed in one of several methods discussed in more detail below). And the same state law rules that govern outside apportionment of the federal estate tax ought to govern apportionment of any state estate tax equal to the §2011 state death tax credit. See, e.g., In re Marital Deduction Trust under Will of Adair, 695 A.2d 250 (N.J. 1997), dealing with the state pick up tax attributable to a QTIP trust that was includible in the decedent's gross estate, as to which state law apportionment rules were deemed to apply, and cf. Cleveland v. Compass Bank, 652 So. 2d 1134 (Ala. 1994), and Branch Banking & Trust Co. v. Staples, 461 S.E.2d 921 (N.C. Ct. App. 1995) (both involving federal estate tax attributable to inclusion of QTIP property in the decedent's gross estate, which yielded a larger state death tax credit that correspondingly increased the state pick up tax equal to that credit, which the court did (not) apportion to the QTIP trust along with the federal estate tax itself depending on whether state law called for apportionment of the federal tax (*Branch Banking*) or imposed the burden on the residue (*Cleveland*), absent an effective provision in the decedent's estate plan):

(a) To the extent not eliminated by changes to §2035, applicable to property transferred within three years of the decedent's death for less than full and adequate consideration and as to which inclusion would have resulted under §§2036-2038 or §2042 had there been no transfer or gift taxes paid with respect to property transferred within three years of the decedent's death;

(b) under §2036(a)(1), property transferred for less than full and adequate consideration as to which the decedent retained the right to income or possession for life or a period not measurable without reference to the decedent's death and that did not end before death;

(c) under §2037, property transferred for less than full and adequate consideration while retaining a prohibited form of reversion;

(d) under §2036(a)(2) or §2038(a)(1), property transferred for less than full and adequate consideration as to which the decedent retained a prohibited degree of control over the enjoyment of income or principal;

(e) under §2039, an annuity (whether payable as a death benefit under an employee benefit plan or otherwise) to the extent the chronological exemptions from repeal of the §2039(c) and (e) exemptions do not apply;

(f) In a community property jurisdiction this §2039 exposure is all the more significant if it is the nonparticipant spouse who dies first, with a community property ownership interest that is includible but not subject to the spouse's control or disposition and almost certainly not in any distribution status; hopefully it qualifies automatically under §2056(b)(7)(C) for the estate tax marital deduction, but this is not necessarily true;

(g) under §2040, property owned as a joint tenant with right of survivorship or as a tenant by the entirety;

(h) under §2041, property over which the decedent possessed a general power of appointment at death;

(i) under §2042, proceeds of insurance on the life of the decedent as to which the decedent possessed incidents of ownership at any time with three years of death (and, under various legislative proposals, insurance on the decedent's life that is payable directly or indirectly to or for the benefit of a third party);

(j) under §2044, qualified terminable interest property as to which the decedent was the income beneficiary at death; or

(k) under §2701(d), potentially the tax incurred on a suspense account would be paid by the recipient thereof; under §2703 the tax attributable to a buy-sell agreement that failed to peg estate tax value; and under §2704 the tax incurred with respect to a deemed transfer.

(2) As illustrated below, it is with respect to outside apportionment that most state apportionment statutes apply and as to which the limited federal apportionment rules exist. However, apportionment to some of the above described forms of nonprobate property is addressed far more clearly and appropriately than it is with respect to other forms.

c. Equitable apportionment involves the question whether dispositions that generate a tax deduction should be freed from contribution toward payment of the total taxes imposed on the estate. If equitable apportionment applies, the deductible disposition alone benefits from the deduction, rather than the deduction benefiting all beneficiaries of the estate.

(1) The most common example of this property passing to a surviving spouse that qualifies for the marital deduction, in which case the question can apply

(a) in an intestate estate in which the spouse takes a statutory share of the estate,

(b) in a testate estate in which the spouse rejects the decedent's estate plan in favor of a statutory forced heir share,

(c) in a testate estate (or will substitute) involving apportionment as between the spouse's bequest (whether as a part of the residue or some other part of the total estate), and

(d) in any estate, to the extent a prenuptial agreement or §2053 deductible property settlement agreement creates a claim against the estate (or a disposition under the will is in satisfaction of such a contractual claim against the estate), with the issue being whether distributions in satisfaction of the claim are subject to apportionment of taxes.

(e) Also the source of equitable apportionment is the §2055 charitable deduction and, although less obviously so, §§2032A(c)(5) and 2057(i)(3)(F) (prior to its repeal in 2004) pose similar issues relating to the reduction in tax attributable to special use valuation or the family-owned business exclusion and the subsequent liability for recapture tax under either.

d. Apportionment of Rate Differentials. Closely related to equitable apportionment is whether to pass along or apportion state wealth transfer tax rate differentials based on each beneficiary's share of the estate (for example, some states impose a tax that favors more closely related beneficiaries over strangers or distant relatives). In such a state the issue is whether any apportionment should reflect these rate differentials.

e. Apportionment of Credits. Similarly related is the question whether to apportion the benefit of credits available to the estate that are connected with separate identifiable properties passing to designated individuals. For example:

   (1) Subject to §§2015 and 2016, if some property incurs more state death tax or foreign death tax than others, the apportionment issue is whether the beneficiaries thereof should receive the benefit of any §2014 credit, respectively, attributable to the tax incurred on their bequests. Now that §2011 has been replaced by the §2058 deduction a similar concept should apply, with equitable apportionment of the benefit of that deduction.

   (2) The §2012 credit for gift taxes paid on pre-1977 transfers of property subsequently included in the estate may be apportioned.

   (3) The §2013 credit for previously taxed property may be apportioned, and can be a source of real inequity if not considered properly. To illustrate:

      (a) Assume that the decedent was beneficiary of a generation-skipping trust created by a parent, with a §2041 general power of appointment to avoid generation-skipping tax. Because the parent and the decedent died within ten years of each other, a §2013credit is available to the decedent's estate. If §2207 liability for the estate tax attributable to the trust is imposed on the remainder beneficiaries of the trust, they also should receive the benefit of that credit, but they do not under most state laws.

      (b) The decedent could match the tax liability with the credit by waiving the §2207 reimbursement entitlement or by apportioning the credit. The issue is whether the decedent's estate can afford to pay the §2041 taxes on the trust. And in a more sophisticated plan in which the generation-skipping tax might be allowed to apply instead of §2041, it would be unwise to have the two tax liabilities payable by different sources, one by the decedent's estate and the other by the trust.

(4) Finally, the §2015 credit for deferred taxes attributable to future interests may be apportioned to the takers of those interests.

f. Apportionment to Temporal Interests. Related to the §2015 issue, a final apportionment alternative relates to the proper method for apportioning taxes attributable to property that is split into temporal interests, such as a life estate, a term of years, or an annuity given to one individual and the remainder or reversion given to another.

g. Apportionment Among Multiple Entities. If several estate planning documents (such as a will and an inter vivos funded trust or an irrevocable unfunded insurance trust) are involved, these issues are compounded by the need to decide how tax payment obligations should be imposed on the multiple entities.

(1) For example, the tax payment provisions in each document could:

(a) provide for payment of all taxes out of the probate estate (with or without inside apportionment);

(b) provide for payment of all taxes from the trust corpus (similarly with or without a form of inside apportionment among several shares created thereunder);

(c) provide for a ratable apportionment of taxes between the several entities (with or without apportionment under each as among the respective shares thereunder);

(d) provide that the trust shall contribute to the payment of taxes only to the extent the probate estate is insufficient to pay all the taxes imposed on the gross estate (or vice versa, and again with questions of apportionment under each disposition);

(e) provide that the trustee shall pay taxes only in the discretion of the trustee (under established guidelines, and with or without apportionment);

(f) provide that the trustee shall pay taxes to the extent the personal representative of the decedent's estate certifies the need therefor (again under guidelines and an apportionment regime that must be specified); or

(g) simply permit the trustee to purchase assets from the estate to provide needed liquidity.

(2) Not incidentally, these decisions must take into consideration the potential for conflicts of interest and the difficulty of exercising discretion if conflicting beneficial interests and different fiduciaries are involved.

h. Decedent's Choice. With respect to all apportionment issues, it is relatively clear that, should the decedent wish to do so,

(1) a testamentary disposition by clear provision may expressly specify the property and the dispositions that will bear the tax burden, permitting alteration of the customary burden on the residue rule;

(2) the decedent also, by a clear provision in a testamentary disposition, may exonerate nonprobate property from any otherwise applicable state law directive requiring outside apportionment; and

(3) although not nearly as clearly permissible, it is relatively well established that the decedent may impose the burden for tax payment on nonprobate assets through the use of a will provision, subject to certain exceptions to be noted below in dealing with the proper method for drafting such a provision. See generally Annot., *Construction and Effect of Will Provisions Expressly Relating to the Burden of Estate or Inheritance Taxes*, 69 A.L.R. 3d 122 (1976).

3. Factors to Consider. In advising a client as to the best apportionment approach, a number of policies or considerations might be relevant, including:

a. With respect to inside apportionment, does the client favor the particular beneficiaries over the residuary takers?

(1) The common law abatement rules presume this to be the case, and failure to permit inside apportionment is consistent therewith.

(2) In reality, often the particular beneficiaries fit into one of the following categories:

(a) First is a marital deduction bequest that the client wants to maximize, in most cases resulting in no tax at the client's death — so apportionment is a moot issue (even if it does not eliminate taxes, however, protection of the deduction is served by equitable apportionment).

(b) Second are those relatively minor dispositions (e.g., "$100 to my brother Fred who said I wouldn't remember him in my will" or "$10,000 to my loyal bartender who swore I wouldn't live this long") that most individuals place in a separate article preceding the heart of the estate plan; with respect to these, the common law abatement and apportionment rules are likely to be directly contrary to the intent of the client in the sense that, if anyone should suffer for insufficient assets in the estate, it should be these takers.

b. With respect to outside apportionment, does the client wish to have the probate estate pay taxes generated by property over which the client has no control?

(1) This is particularly important with respect to §2044 qualified terminable interest property, especially in the second marriage or related situations in which the QTIP property passes to beneficiaries for whom the surviving spouse has no affinity.

(2) It is conceivable that inclusion could result (under §§2036 through 2038, 2701(d), and under §2042 if proposals that eliminate the ability to remove insurance proceeds from the gross estate using an irrevocable insurance trust ever are adopted) in the context of transfers over which the client may have no meaningful control at death.

(3) Employee benefits that generate §2039 liability also could be beyond effective control due to the §401(a)(11) spousal annuity rules or the plan terms (especially if Death Benefit Only plan inclusion legislation or reversal of Estate of DiMarco v. Commissioner, 87 T.C. 653 (1986), occurs. See Estate of Levin v. Commissioner, 90 T.C. 723 (1988)).

c. With respect to the issue of equitable apportionment involving the marital deduction (and, to a certain extent, involving the charitable deduction as well):

(1) Should the deductible share bear no tax because it generated no tax?

(a) With an "optimum" or unlimited marital deduction, any normal estate tax imposed on the estate would be generated by property that did not qualify for the deduction.

(b) Most individuals embrace the notion that the marital deduction is designed for the benefit of the surviving spouse and, therefore, that the spouse ought to be the sole beneficiary of the deduction. A similar argument could be made in favor of charity, perhaps with even greater merit because it is unclear whether the marital deduction was intended as a benefit solely for the spouse as opposed to a benefit to the estate in general. For example:

i) Section 2056(b)(4)(A) provides that "In determining for purposes of subsection (a) the value of any interest in property passing to the surviving spouse for which a deduction is allowed by this section — (A) there shall be taken into account the effect which the tax imposed by section 2001, or any estate, succession, legacy, or inheritance tax, has on the net value to the surviving spouse of such interest . . . ."

ii) This seems to indicate that Congress anticipated that taxes might be paid out of the marital share, which may suggest that Congress did not anticipate that the marital would be tax free (although this may only indicate that Congress could not predict whether state law would match the federal tax free marital deduction).

iii) Moreover, §2056 is available to the estate of any individual; until the adoption of §2056(d), the status of the surviving spouse was irrelevant, which also seems to indicate that the spouse was not the focus of Congress' attention when the marital deduction was first introduced to the Code. Not even the adoption of §2056(d) indicates a shift in Congress' vision of who is "entitled" to the benefit of the deduction in the tax apportionment sense.

iv) Contrariwise, however, the last sentences of §§2206 and 2207 (federal apportionment provisions that are discussed below) appear to favor marital deduction dispositions by apportioning taxes away from the marital:

Section 2206: In the case of such proceeds receivable by the surviving spouse of the decedent for which a deduction is allowed under section 2056 (relating to marital deduction [sic], this section shall not apply to such proceeds except as to the amount thereof in excess of the aggregate amount of the marital deductions allowed under such section.

Section 2207: In the case of such property received by the surviving spouse of the decedent for which a deduction is allowed under section 2056 (relating to marital deduction [sic], this section shall not apply to such property except as to the value thereof reduced by an amount equal to the excess of the aggregate amount of the marital deductions allowed under section 2056 over the amount of proceeds of insurance upon the life of the decedent receivable by the surviving spouse for which proceeds a marital deduction is allowed under such section.

v) Authority supports each proposition: for examples of those holding that the deduction is meant to benefit the entire estate and not just the surviving spouse, see Robinson v. United States, 518 F.2d 1105 (9th Cir. 1975); In re Mosby's Estate.

554 P.2d 1341 (Mont. 1976); and Estate of Marans v. Newland, 390 P.2d 443 (Mont. 1964).

vi) With respect to the converse position, see Kahn, The Federal Estate Tax Burden Borne By a Dissenting Widow, 64 MICH. L. REV. 1499 (1966); and Note, Estate and Gift Tax: Federal Estate Tax – Burden on a Marital Share. 33 OKLA. L. REV. 384 (1980).

(2) To the extent the purpose of the intestate or forced heir marital share is to protect the surviving spouse, it can be argued that this protection should be maximized by computing the marital share without diminution by taxes.

(3) Because the original purpose of the marital deduction was to provide equality between common law and community property spouses, arguably at least a portion of the marital share should be computed without reduction by taxes in a common law state (because a surviving spouse takes half the community estate tax free in a community property state).

(4) But perhaps the most persuasive argument in favor of equitable apportionment is that, if the marital share bears a portion of the taxes imposed on a decedent's estate (because equitable apportionment does not apply), the deduction itself will be reduce under §2056(b)(4)(A). Indeed, the marital deduction will be reduced by the full amount of tax that *could* be paid, even if for some reason it is not. See Jeschke v. United States, 59 A.F.T.R.2d ¶148,886 (10th Cir. 1987); Adee Trust No. 1 v. United States, 52 A.F.T.R.2d ¶148,598 (D. Kan. 1983); Estate of Reno v. Commissioner, 90-2 U.S. Tax Cas. (CCH) ¶60,046 (4th Cir. 1990); Private Letter Rulings 8622022, 8517036, 8508022, and 8450018, and cf. Pyne v. United States, 86-2 U.S. Tax Cas. (CCH) ¶13,677 (D. Me. 1986) (if equitable apportionment had not applied, marital deduction would have been reduced).

(a) In some cases a reduction in the deduction correspondingly increases taxes that further serve to reduce the size of the marital share (because that share is a portion of the total estate available for distribution), which further increases taxes that again reduce the deduction, ad nauseam. See, e.g., Estate of Lewis v. Commissioner, 69 T.C.M. (CCH) 2396 (1995) (tax burden imposed on residuary estate, which would qualify for the marital deduction, coupled with waiver of apportionment and reimbursement rights, caused loss of deduction because tax on preresiduary bequests unexpectedly exceeded unified credit; result was circular whirlpool reduction of deduction as more tax was produced by increasing loss of deduction to pay increasing tax).

(b) Consider the following example illustrating the comparative computations (using 2005 rates and credits) of a one-third forced heir share or intestate entitlement of a surviving spouse in an estate of $2.4 million:

1/3 of "Gross" Estate (i.e. <u>before</u> taxes)		1/3 of "Net" Estate (i.e. <u>after</u> taxes)
$2,400,000	Estate	$2,400,000
800,000	Marital	782,353
1,600,000	Taxable	1,617,647
45,000	Taxes	52,941
1,555,000	Residue	1,564,706

(c) The final result is: a net estate division produces a marital share exactly half the size of the remaining residue, preserving the 1/3 x 2/3 division dictated by the marital entitlement provision, but the method of computation generates a smaller marital deduction (by $17,647) and more taxes (by $7,941); curiously, the residue is actually better off (by $9,706) because of it.

(d) The issue whether the marital share should be a fraction of the net estate (after taxes) or the gross estate (before taxes) is simply the equitable apportionment issue working to protect the marital share from bearing a portion of the taxes in the gross estate division but not in the net estate computation. See In re Estate of Thompson, 512 N.W.2d 560 (Iowa 1994) (net estate division required); Technical Advice Memorandum 8640009 (gross estate division adopted).

(e) To say that the issue is confused is an understatement; as an illustration, consider the situation in Illinois, where it apparently makes a difference whether the computation is to determine the intestate entitlement of a surviving spouse as opposed to the statutory force heir marital share of a spouse who is rejecting a decedent's estate plan by electing against it. See Note, *In re Estate of Gowling and In re Estate of Grant: The limits of Equitable Apportionment*, 13 LOYOLA L.J. 309 (1982).

(f) Further, in considering the proper division involving an election against the estate, a tax clause in the decedent's will is irrelevant because, by virtue of the election, the surviving spouse is deemed to reject any and all provisions in the will for the benefit of the spouse, including the tax clause (the so-called doctrine of "equitable election"). See Merchants Nat'l Bank and Trust Co. v. United States, 246 F.2d 410 (7th Cir. 1957); In re Estate of Thompson, 512 N.W.2d 560 (Iowa 1994); Annot., *Surviving Spouse Taking Elective Share as Chargeable With Estate or Inheritance Tax*, 67 A.L.R.3d 199 at §5 (1975).

(g) Similar disputes arise in applying the concept of equitable apportionment to the charitable deduction under §2055 and the question whether division ought to be before or after taxes. See, e.g., YMCA v. Davis, 264 U.S. 47 (1924). Under §2055(c), any tax burden on a charitable bequest reduces the charitable deduction.

C. Federal Rules Applicable to Apportionment.

1. Section 2205 establishes the general rule that distinguishes the federal estate tax from an inheritance tax, specifying that

If the [federal estate] tax . . . is paid by, or collected out of, that part of the estate passing to or in the possession of any person other than the executor . . . such person shall be entitled to reimbursement . . . it being the purpose and intent of this chapter that . . . unless otherwise directed by the will of the decedent the tax shall be paid out of the estate before its distribution.

2. This federal rule, calling for payment from the residue of the estate, applies only if state law does not provide to the contrary or the decedent's will does not direct otherwise, and is subject in all events to four federal statutory rules that permit reimbursement for federal (but not any state) estate tax imposed on specific types of nonprobate property.

3. Reimbursement for Tax on Insurance Proceeds. Section 2206, added to the Code in 1918 (the oldest such form of reimbursement provides that

[u]nless the decedent directs otherwise in his will, if any part of the gross estate on which tax has been paid consists of proceeds of policies of insurance on the life of the decedent receivable by a beneficiary other than the executor, the executor shall be entitled to recover from such beneficiary such portion of the total tax paid as the proceeds of such policies bear to the taxable estate. If there is more than one such beneficiary, the executor shall be entitled to recover from such beneficiaries in the same ratio. In the case of such proceeds receivable by the surviving spouse of the decedent for which a deduction is allowed under Section 2056 (relating to marital deduction) [sic], this section shall not apply to such proceeds except as to the amount thereof in excess of the aggregate amount of the marital deductions allowed under such section.

a. Established is a right of reimbursement for taxes paid by the estate, the personal representative being entitled to collect from every beneficiary of includible insurance proceeds the proportionate share of the total taxes paid by the estate that is attributable to such insurance.

b. As established by case law, this right of reimbursement is not applicable with respect to annuities, even if underwritten by an insurance company. See Annot., *Construction and Application of Statutes Apportioning or Prorating Estate Taxes*, 71 A.L.R.3d 247 at 302-303 (1976).

c. In addition, by the greater weight of authority, reimbursement may not be asserted against the insurer, even if the proceeds have not yet been distributed to the designated beneficiary; most cases hold that the personal representative must recover from the beneficiary. See Annot., *Remedies and Practice Under Estate Tax Apportionment Statutes*, 71 A.L.R.3d 371 at 409-410 (1976).

d. Great care should be exercised to avoid waiver of this right (as authorized under the introductory clause of §2206). In this regard, consider In re Estate of Kapala, 402 N.W.2d 150 (Minn. Ct. App. 1987), in which the decedent owned insurance on his life, payable to his partner to provide liquidity under a buy-sell agreement when the decedent died.

   (1) Section 2042 inclusion applied and the court found that §2206 reimbursement was not waived, notwithstanding the buy-sell agreement providing that the surviving partner would receive all assets "free and clear of all claims of every kind."

   (2) The court determined that waiver of §2206 must appear in an instrument with testamentary intent, which it found the buy-sell agreement to lack. There may be precedential value in this element of the case for §2703 purposes.

e. If §2042 were amended to include insurance not owned by the decedent and over which the decedent possessed neither incidents of ownership nor control, §2206 might be the only way to afford the taxes caused by inclusion in some estates. Thus, even in planning under current law with respect to any irrevocable insurance trust, the settlor-insured ought to either preserve §2206 or include a contingent tax clause in the trust, dictating (at the least) payment of taxes to the extent the decedent-insured's estate is insufficient.

f. Also consider Estate of Boyd v. Commissioner, 819 F.2d 170 (7th Cir. 1987), in which the court found that the decedent's waiver of the §2206 reimbursement right constituted a "bequest" from the decedent to the beneficiary of the proceeds of the policy, which "bequest" that beneficiary could disclaim. In re Estate of Fogelman, 3 P.3d 1172 (Ariz. Ct. App. 2000), similarly treated a waiver of the §2206 right of reimbursement as a bequest, in that case that failed because the estate was insolvent. In *Boyd*, the effect of the disclaimer was to pay taxes from the proceeds (which were payable to a child) and preserve the decedent's residue (which passed to the surviving spouse and qualified for the marital deduction). A smaller marital deduction would have been available if the decedent's waiver had not been "reversible" by the child's disclaimer.

4. Reimbursement for Tax on Power of Appointment Property. Added with the power of appointment provisions in 1942 and employing virtually identical language to §2206, §2207 grants an identical right of reimbursement for taxes attributable to "property included in the gross estate under section 2041."

   a. The personal representative may recover from "the person receiving such property by reason of the exercise, nonexercise or release of a power of appointment."

   b. Waiver of this provision also is allowable under the authority of *Boyd*, just as is waiver of the §2206 right of reimbursement. See Private Letter Ruling 200127007 (waiver of the §2207A right of reimbursement is an interest in property that may be disclaimed).

5. Reimbursement for Tax on QTIP Property. Added in 1981 with adoption of §2044 and the §2056(b)(7) qualified terminable interest property trust. Section 2207A grants a significantly different right of reimbursement.

   a. Applicable to property "which is includible in the gross estate by reason of section 2044 (relating to certain property for which marital deduction [sic] was previously allowed)," this right of reimbursement differs because it is an incremental rather than a proportionate entitlement.

      (1) Sections 2206 and 2207 apply to bottom line taxes imposed on the estate with respect to those portions causing inclusion under §§2042 and 2041, respectively (and after considering the marital deduction), effectively prorating all deductions and credits proportionately among all takers.

      (2) Section 2207A permits recovery of the amount by which taxes were increased by inclusion of §2044 property, meaning the incremental taxes without benefit of deductions or credits available to the estate as a whole.

      (3) The difference between these reimbursement provisions is illustrated in Sarosdy v. Johnson, 804 S.W.2d 640 (Ky. Ct. App. 1994), in which a general power of appointment versus a QTIP marital trust was involved, the estate was entitled to only pro rata reimbursement under §2207 rather than incremental reimbursement under §2077A, meaning that

estate tax attributable to inclusion of the marital trust was payable in part from the decedent's own property, which would have passed totally free of tax under the decedent's unified credit had the marital trust not been includible.

(4) Thus, if the spouses agreed that the survivor would have the use of the decedent's wealth for the survivor's overlife, but that their respective shares would pass at the survivor's death to their respective beneficiaries, §2207A disrupts the intended equity of that plan by imposing a greater than pro rata share of the survivor's taxes on the decedent's QTIP property. Only if the survivor is willing to alter the incremental dictate of §2207A by a provision in the survivor's will would this be avoided, and the decedent cannot guarantee that the survivor will do so.

(5) It may be that no modification is appropriate, however, because the inequity is balanced by the fact that the surviving spouse's unified credit reduces that tax imposed on all the beneficiaries interested in the surviving spouse's estate tax computation, including whose who take the QTIP trust remainder as well as the survivor's other beneficiaries, while the decedent's unified credit benefited the beneficiaries of the decedent's bypass trust entirely.

b. The §2207A right of reimbursement extends to gift taxes caused under §2519 by relinquishment of any portion of a qualified terminable interest; no similar right exists under either of the §2206 or §2207 reimbursement provisions if gift taxes are incurred on insurance proceeds or power of appointment property.

(1) Section §2207A does not, however, allow recovery of gift taxes incurred under §2511 as, for example, if the beneficiary of a QTIP trust assigned a portion of the right to receive income and incurred gift tax on both the §2511 gift of income and the §2519 imputed transfer of the remainder interest in the entire QTIP trust.

(2) In addition, §2207A does not grant any right inter vivos to recover the benefit of any unified credit "used" on such a lifetime transfer under either §2511 or §2519. The effect is to "use" the unified credit on the §2511 transfer first, then on the §2519 transfer.

c. Section 2207A(d) specifies that interest and penalties attributable to §2204 property are subject to the incremental right of reimbursement. This also has no counterpart in §§2206 and 2207.

d. According to Treas. Reg. §20.2207A-1(a)(2), failure to assert the right of reimbursement constitutes a gift from the beneficiaries of the spouse's estate to the beneficiaries of the QTIP property who benefit from that failure, although Treas. Reg. §20.2207A-1(a)(3) states that this can be avoided to the extent the surviving spouse's will expressly waives the right of reimbursement or the beneficiaries cannot otherwise compel recovery.

e. Quaere what happens if the decedent's personal representative neither reports the QTIP trust nor asserts the §2207A right of reimbursement: do the beneficiaries of the surviving spouse's estate make a gift, and how would anyone know?

f. These dangers might encourage waiver of the right of reimbursement, but the magnitude of §2044 inclusion in some estates causes the inability to assert the right of reimbursement to have calamitous consequences, as the following example indicates:

(1) Decedent was the beneficiary of a QTIP trust that passed to the surviving children of the settlor (who was Decedent's second spouse); those children were not Decedent's children.

(2) Decedent, who had been married several times, created a QTIP trust for Decedent's surviving (third) spouse, and created a bypass trust to benefit Decedent's children from Decedent's first marriage.

(3) Inclusion of the second spouse's QTIP in Decedent's estate generated sufficient taxes to wipe out Decedent's bypass trust and exhaust a portion of the Decedent's marital deduction trust (created for Decedent's surviving (third) spouse). Obviously §2207A should have been preserved in Decedent's will.

g. Similar problems have been experienced by attorneys in cases in which a decedent's bypass trust was consumed by state death taxes or expenses of administration. These also could be the subject of apportionment under the decedent's estate plan in an effort to more equitably share those burdens among varying and disparate beneficiaries of the estate.

h. Another interesting issue arose in a case in which the surviving spouse did not waive §2207A and the survivor's own property was less than the applicable exclusion amount, meaning that all estate tax payable in the survivor's estate was attributable to the QTIP trust that passed to children of that trust's settlor. Those children wanted to pay their tax to stop the running of interest and penalties, but the surviving spouse's personal representative refused to file a return for the survivor's estate and denied all requests to provide accurate information about the spouse's estate. The QTIP trustee finally filed a return showing just the QTIP trust assets, reporting the estate assets as unreturned, and forcing the spouse's estate to file on its own.

i. In proposed form Treas. Reg. §25.2519-1(a) established the principle that the gift under §2519 is the value of the corpus less the amount of any §2207A reimbursement to which the surviving spouse was entitled, and in proposed form Treas. Reg. 20.2207A-1(a) established the proposition that the spouse made an added gift of the amount of the reimbursement if it was not collected.

(1) Treas. Reg. §20.2207A-1(a)(2) continues to state that the beneficiaries of an estate make a similar gift if the estate fails to collect reimbursement, although §20.2207A-1(a)(3) provides that this gift does not occur to the extent the beneficiaries cannot compel recovery and gives as an example that the spouse waived the recovery right by will.

(2) This provision also gives as an example the surviving spouse's executor exercising discretion granted by the spouse's will to waive the right of recovery. The example is a bit odd, for two reasons.

(a) First, if there would be no benefit by virtue of a waiver, because the beneficiaries with the right and those subject to it are the same, there would be no gift attributable to the waiver and the example is not useful. If, however, the beneficiaries are not the same and a benefit therefore is bestowed by the executor's waiver, it would be unusual that a fiduciary would abandon a valuable right such as the ability to seek recovery, because the effect is to benefit one set of individuals over another.

(b) Second, the example does not indicate who was acting as executor, which would appear to be an important fact. Notwithstanding these quibbles, Prop. Treas. Reg. §20.2207A-1(a)(2) provided that any failure to assert the right of recovery was a gift "even if recovery is impossible"; this too was deleted from the final regulation.

j. As illustrated only obliquely by Treas. Reg. §25.2207A-1(f), the §2207A right of reimbursement for gift taxes does not extend to any tax imposed under §2511 on the gift of the income interest and §§20.2207A-1(c) and 25.2207A-1(d) effectively provide that the principles of equitable apportionment will apply in determining which recipients of property subject to §2044 or §2519 will bear the cost of reimbursement. For example, if the property passes to a surviving spouse of the surviving spouse or to a charity, in either case qualifying for a deduction and therefore causing no tax, the recipient would not be required to contribute to the §2207A reimbursement.

k. In early 2002 the Treasury Department reissued the exact same proposed regulation first introduced in 1984 and later withdrawn. First it elaborated on the principle established under Prop. Treas. Reg. §25.2519-1(a) that the gift under §2519 is the value of the corpus less the amount of any §2207A reimbursement to which the surviving spouse was entitled. Then it reinstated the Prop. Treas. Reg. §25.2207A-1(a) proposition that a spouse makes an added gift of the amount of the reimbursement if it is not collected, and that any "delay" in enforcement itself constitutes a gift (without elaboration on what "delay" means).

l. Curiously, Prop. Treas. Reg. §25.2519-1(c) recognized that the donee of property subject to the §2207A right of reimbursement receives less value than if the right of reimbursement did not exist. That regulation therefore provides that the value of any §2519(a) gift to the donee is calculated as a net gift, reducing the fair market value of the property subject to §2519(a) by the amount of the §2207A(b) reimbursement. That sensible provision, omitted once from the final regulations, now is restored by Treas. Reg. §§25.2207A-1(b) and 25.2519-1(c)(4).

m. The government worries about the tax consequences of the spouse not requesting the §2207A(b) reimbursement but instead remitting other funds in payment of the tax under §2519(a). The proper result—now also embraced by the now final regulation— is to regard the spouse's waiver of or failure to assert the right of reimbursement as an additional gift, itself subject to tax.

n. The theoretically correct treatment is to treat this gift as being made either in the year in which the spouse paid the gift tax under §2519(a) or the year in which it no longer is possible to assert the §2207A(b) right of reimbursement.

   i. As a practical matter it might be easier to treat all gifts as occurring in the year of the original transfer that triggered §2519(a), rather than requiring a net gift computation in that year and an additional gift tax determination in a subsequent year. Nevertheless, the regulation takes the more cumbersome but theoretically correct approach: the gift occurs when the right of recovery no longer is enforceable, and adds the notion that this lapse of the right of reimbursement "is treated as a gift even if recovery is impossible."

   ii. The spouse cannot even indicate on the gift tax return reporting the §2519(a) transfer that the §2207A(b) right of reimbursement will not be asserted and therefore that the gift is the full §2519 amount unreduced by the §2207A(b) right of reimbursement – effectively releasing the right of reimbursement and accelerating the year of the gift. Perhaps the spouse can just file an amended gift tax return when it becomes clear that the reimbursement right will not be asserted.

o. A tax simplification change made it impossible to waive §2207A without "specifically indicat[ing] an intent to waive" the right of reimbursement, thereby avoiding inadvertent waivers of the variety that have produced problems in several notable cases. See the discussion of the *Gordon* case at page 111. That same change added the ability to waive the right by a provision in the decedent's revocable trust as well as in the decedent's will. Neither of §2206 nor §2207 so permit. See the discussion of *Estate of Roe* at page 120 regarding use of wrong instrument to waive reimbursement rights.

6. Somewhat like a QTIP trust is the Qualified Domestic Trust of §2056A, applicable with respect to any decedent whose surviving spouse is not a citizen of the United States.

   a. Section 2056A(b) imposes an estate tax upon certain events, such as if the trust ceases to qualify as a Qualified Domestic Trust or if distributions of corpus are made during the surviving spouse's overlife, and at the surviving spouse's death.

   b. By §2056A(b)(2) the tax is computed at the decedent-settlor's rates and is imposed ab initio on the trustee under §2056A(b)(5).

   c. In this respect, §2056A differs from the treatment of a normal QTIP trust under §§2044, 2519, and 2207A because the tax is not computed at the surviving spouse's estate or gift tax rates and the provision that imposes the tax on the trust property cannot be waived or overridden by the surviving spouse's estate plan.

   d. Nevertheless, the fundamental apportionment aspect is that the tax is paid out of the Qualified Domestic Trust property.

7. <u>Reimbursement for Tax on Section 2036 Property</u>. Section 2207B applies to taxes caused by inclusion of property under any part of §2036 (not just §2036(c), which was the Code provision that prompted this addition; §2207B remains in the Code, notwithstanding repeal of §2036(c) and replacement of it with Chapter 14).

   a. Section 2207B calls for a pro rata right of reimbursement, like §§2206 and 2207, but includes penalties and interest attributable to the tax in the amount subject to reimbursement, like §2207A.

   b. Also like §2207A, the entitlement created by §2207B may be waived by the decedent's revocable inter vivos trust as well as by a will, and the requirement that any waiver "specifically indicates an intent to waive" the reimbursement right, whatever that means. The tax simplification proposal that added the same requirement to §2207A was accompanied by legislative history that almost surely will become part of the regulations when issued, providing that "a specific reference to QTIP section 2044, or section 2207A" would suffice, and presumably a similar reference to §2036 or §2207B would suffice for this provision — although the legislative history was silent on this issue for §2207B purposes.

c. It has not been determined whether failure to waive or assert the §2207B right of reimbursement will result in a gift of the type imposed under §2207A.

8. For reasons that probably are more historical than substantive, there is no comparable federal provision for recovery of taxes attributable to nonprobate assets includible under §§2035 and 2037 through 2040 and none with respect to estate tax aspects of Chapter 14, although a move has been afoot for over a decade to enact a provision similar to §2207A for the taxes caused by inclusion of §2039 employee benefits in a decedent's gross estate.

   a. It is sensible to seek such an addition because these benefits typically pass outside probate and often constitute a large share of the estate, risking bankruptcy of the probate estate in payment of estate taxes absent a right of reimbursement.

   b. One underlying justification for §§2207 and 2207A is that the decedent did not create the interest that generated the estate tax liability under §2041 or §2044. The absence of this element in most situations involving inclusion under §§2035 and 2037 through 2040 is not a persuasive justification for the lack of a right of reimbursement, however, given the fact that §§2206 and 2207B usually apply to insurance proceeds at to which decedent possessed incidents of ownership that caused inclusion in the estate or property transferred during life in a manner that triggers §2036.

   c. There has been some suggestion that the Treasury Department regards each of §§2206 through 2207B as matters properly left to state property law.

      (1) Thus, it is suggested that, because these sections are not related to the imposition or collection of taxes in the first instance, Treasury has no interest in adding a Code provision relating to §2039 or other nonprobate assets.

      (2) Addition of a provision comparable to §§2206 through 2207B, or a deferral rule like §§6161 through 6166, or a "pay as you go" rule like Treas. Reg. §20.2056A-4(c), is not high on any list of tax reform priority. This is particularly unfortunate, given the magnitude of some of these assets relative to a decedent's total estate and the assets otherwise available to pay taxes caused by their inclusion.

   d. Note, however, that source of payment concerns are not easily addressed if the employee benefit proceeds are designated for installment payment; at a minimum, plan actuarial assumptions that inform plan liquidity considerations would need to anticipate imposition of potentially large one-time distributions in cases in which the proceeds do not qualify for the marital or charitable deductions.

9. Sections 2206 and 2207 (but not 2207A and 2207B) also contain a provision that "allocates" the marital deduction in an estate, first to insurance proceeds and then to power of appointment property.

   a. By the last sentence of §§2206 and 2207, the right of reimbursement is inapplicable to the extent a surviving spouse receives proceeds of insurance or property subject to a general power of appointment, in either case to the extent qualifying for the §2056 marital deduction.

   b. As between the two provisions, §2207 presumes that insurance proceeds first qualify for any available marital deduction, with §2041 power of appointment property filling only any excess of the amount of the deduction over the amount of insurance proceeds passing to the spouse and qualifying for the deduction.

   c. The effect of these presumptions is to reduce any otherwise applicable reimbursement right in an estate that qualifies for the marital deduction. In effect, these sections work as a form of equitable apportionment, denying apportionment through reimbursement against assets deemed to qualify for the deduction.

   d. Neither section has a similar provision with respect to the charitable deduction, and §§2207A and 2207B are devoid of a comparable provision altogether.

      (1) Treas. Reg. §20.2207A-1(a)(1) reflects that an equitable apportionment rule is unnecessary because the §2207A increment in tax attributable to an asset that qualifies for either a marital or a charitable deduction is zero, but this effect does not apply with respect to the pro rata right of reimbursement in §2207B.

      (2) In effect, then, §§2206, 2207, and 2207A embrace equitable apportionment with respect to the marital deduction, but only §2207A does so with respect to the charitable deduction, and that only by virtue of the incremental reimbursement regime.

      (3) Curiously, by express provision, §2207B(d) provides specifically that no taxes will be apportioned under §2207B to a qualified charitable remainder trust, but it has no counterpart with respect to the marital deduction.

10. All of §§2206, 2207, 2207A, and 2207B appear to deny reimbursement for taxes deferred under §§6161, 6163, 6166 and not yet *paid*, which may be equitable (why should the recipient provide reimbursement before the estate tax is paid) and avoids administrative problems such as:

    a. when a deferred payment would occur with respect to property subject to reimbursement (that is, would a pro ration or some other rule apply with respect to all deferral property), and

    b. tracking down the beneficiary to enforce reimbursement many years in the future.

11. Generation-Skipping Tax Apportionment. Finally, the generation-skipping transfer tax contains its own reimbursement provision in §2603.

    a. Section 2603(a) specifies that the distributee pays the tax in a taxable distribution, the trustee in a taxable termination, and the transferor (or the transferor's estate) in a direct skip.

    b. Section 2603(b) does not conform to the legislative language in each of §§2207A and 2207B but instead provides that "unless otherwise directed pursuant to the governing instruments *by specific reference to the tax imposed by this chapter*, the tax imposed by this chapter on a generation-skipping transfer shall be charged to the property constituting such transfer" (emphasis added).

    c. Collectively the two provisions in §2603(b) appear to establish a single, easily stated rule: in essence, "the person with the generation-skipping property pays the tax using that property."

    d. Like most simplifications, this statement is not entirely accurate.

        (1) For example, because the transferor (or the transferor's estate) pays in the case of direct skips, the picture is drawn of a transfer that triggers the tax, with the transferor holding out enough dollars to pay the tax thereon.

            (a) Because the tax is computed "exclusive" of the dollars used to pay the tax, however, in reality the transferor makes the direct skip transfer and then comes up with additional dollars to pay the tax.

            (b) So §2603(b) is a fiction in the case of a direct skip because the tax is not in fact paid from the property that constituted the transfer.

                i) Indeed, §2515 recognizes this, in the sense that it imposes a gift tax on the dollars used by the transferor to pay the direct skip tax, to insure that these dollars do not also escape gift tax liability.

ii) A net gift (or some other form of apportionment) presumably will not avoid this gift tax consequence because §2515 speaks to tax imposed on the donor, not just those paid by the donor.

(c) There probably are two reasons why §2603 is drafted as it is.

i) If the transferor does not produce the added dollars to pay the direct skip tax, then transferee liability and lien provisions (incorporated by reference in §2661) allow the government to proceed against the transferee who received the direct skip property.

ii) The transferor also is protected in the case of an inadvertent direct skip. For example, assume the transferor gives property to a child, who disclaims, causing a direct skip because the property passes to the child's descendants. If the transferor did not anticipate the generation-skipping transfer tax, §2603(b) comes to the rescue by imposing the tax on the transferred and then disclaimed property received by the child's descendants.

(2) In most other cases, however, §2603(b) merely states what should seem obvious: the trustee who holds the property following a taxable termination, or the distributee who just received a taxable distribution, should use the property to pay the tax imposed under §2603(a).

e. A number of interpretative questions likely will arise under these provisions.

(1) What constitutes a sufficiently "specific reference to the tax imposed" by chapter 13 to overcome §2603(b)? Estate of Monroe v. Commissioner, 104 T.C. 352 (1995), held that a garden variety tax payment provision referring to "federal estate taxes . . . or other death taxes attributable to" certain bequests without specification or explicit reference to generation-skipping transfer taxes of Chapter 13 of the Code was not adequate to overcome the §2603(b) regime. Similarly, In re Estate of Tubbs, 900 P.2d 865 (Kan. Ct. App. 1995), held that a general reference to "estate, inheritance, and death taxes" was not the required explicit mention of the generation-skipping transfer tax anticipated by §2603(b). These are the right result. A general waiver of reimbursement rights should not suffice, which (at least in many direct skip situations) probably is appropriate because some transfers will be inadvertent or unexpected and the transferor may not have considered the unexpected tax thereon when directing in a standard tax payment

provision that all taxes be paid from the residue of the transferor's estate, without reimbursement.

(2) If a decedent's will bequeaths, for example, \$2 million to grandchild as a direct skip transfer, does this indicate an intent to leave \$2 million *after* the generation-skipping tax is paid from other sources or is \$2 million to be set aside to be used to pay the tax as directed by §2603(b), with only the balance actually passing to the grandchild?

(a) Without more, the Code dictates the latter result, in which case the tax (assuming no exemption or exclusion applies) would be computed (in 2005) as:

$$[\text{rate}] \times [\text{transfer (after tax)}] = [\text{tax}]$$

$$.47 \times \frac{\$2 \text{ million}}{1.47} = \$639{,}456$$

and the grandchild would receive \$2 million less this tax = \$1,360,544.

(b) As illustrated in the Form 706 Estate and Generation-Skipping Tax return, another formula to make this computation (in 2005) is:

$$\frac{\text{Transfer (before tax)}}{3.1276595} \text{ where } 3.1276595 = \frac{1 + \text{rate}}{\text{rate}}$$

(c) As illustrated in Technical Advice Memorandum 9822001, any interest is computed on the direct skip tax would not be reflected in these calculations.

(d) If this is not the decedent's intent, then the document must clearly override §2603(b), causing a greater amount to be subject to the tax (\$2 million rather than the \$1,360,544 in the prior example) and causing the tax thereon to be greater (\$940,000 rather than \$639,456).

(e) Fortunately, because the tax itself is not subject to the generation-skipping tax, there is no algebraic circularity caused by increasing the bequest and thereby increasing the tax. Nevertheless, the difference in result is dramatic and should not be left to postmortem determination of the decedent's intent.

(3) Another interpretative question is whether taxes imposed on a direct skip transfer are subtracted before determining the inclusion ratio, or whether the exemption is applied first, followed by a portion of the \$1 million exemption being "wasted" by §2603(b) taking a portion of the

transferred property to pay the tax. The proposed generation-skipping regulations do not address this question.

(a) Here the answer should be that the inclusion ratio denominator ("the value of the property . . . involved in the direct skip") is the amount subject to the tax ($1,360,544n the prior example), not the amount actually transferred but before payment of the tax.

(b) Section 2642 is not, however, clear on this point. Indeed, §2642(a)(2)(B)(ii) specifies that the denominator shall be reduced by any estate or death taxes actually recovered from the transferred property, but says nothing about generation-skipping tax, indicating perhaps that a contrary result was intended (assuming Congress and the legislative drafters even considered this issue).

(c) Adding to the lack of clarity is the clear fact that, if a trust were only partially exempt and suffered a taxable termination or made a taxable distribution payment of the generation-skipping tax using trust or distributed assets would use partially exempt dollars to pay the tax, thereby "wasting" exemption on the tax payment. A legitimate question is whether a direct skip should be treated any differently.

i) The simplistic answer is that direct skips should be treated differently because they are taxed "exclusive" of taxes imposed, unlike taxable terminations and taxable distributions.

ii) This misses the mark. The issue is not whether the generation-skipping tax is imposed on the dollars used to pay the direct skip tax; the issue is whether the exemption is wasted in paying the direct skip tax.

iii) Although these are not the same questions, a proper interpretation would be that the exemption should be applied to the amount of the direct skip, not to the full amount transferred before payment of the tax. This is consistent with the tax exclusive intent of Congress to favor the direct skip and is supportable (even though not explicitly stated) by the language of §2642.

(4) One commentator gives two additional examples of situations in which §2603 is not clear:

(a) Assume that T is the income beneficiary of a trust and assigns that income to T's grandchild. As a taxable gift and a direct skip, this is one of the rare cases in which §2603(a)(2) may apply ("a direct skip from a trust," in which case the trust pays the tax) rather than §2603(a)(3) (which directs that the transferor pays the tax). Even if that is not the correct conclusion, the further question is how to apply §2603(b), which says that the direct skip tax should be paid from "the property constituting such transfer," which is an income interest.

i) One analogy is that T received the income and made a direct skipping gift, making §2603(a)(3) applicable and removing this from the "direct skip from a trust" category.

ii) But, realistically, this transfer comes directly out of the trust as income is paid to the grandchild, which presumably is just the type of situation anticipated by §2603(a)(2).

iii) In either case, the property constituting the transfer is an income interest. Because the generation-skipping tax cannot be paid as income is received and paid to the grandchild, and because the tax imposed likely would exceed the income available in the year of the assignment, presumably the tax would be paid from trust principal.

iv) As discussed below, imposing the tax on trust principal here only *appears* to be the wrong result (notwithstanding that it seems to shift the tax liability from the income beneficiary to the remainder beneficiaries), because reducing the principal correspondingly reduces income subsequently earned thereon, thereby effectively amortizing the tax out of income.

v) Thus, notwithstanding some lack of clarity in the rule, it should be that the trust will pay from corpus, particularly because regarding this as a direct skip from T, not from the trust, followed by T paying the tax to avoid this income versus principal issue, would trigger §2515. And all these problems would arise if T failed to pay the tax and the government asserted liability against the property subject to the transfer.

vi) In any case, if the tax is paid out of the property subject to this direct skip transfer (whatever that may mean), the amount subject to tax is only the remaining balance.

(b) As a second example, assume that a decedent names a grandchild as beneficiary of insurance on the decedent's life. Is the direct skip represented thereby at decedent's death "from a trust" for purpose of §2603(a)(2), presumably meaning that the insurer would be treated like a trustee and would be primarily liable to pay the generation-skipping tax? And, in any event, must the tax be paid from the insurance proceeds under §2603(b)?

i) The "clean" result is to say that an insurance policy is not the same as a trust, thus making §2603(a)(3) apply (the decedent's estate would pay the tax).

ii) Then §2603(b) would act like §2206, meaning the grandchild, as recipient of the insurance proceeds, would reimburse the decedent's estate for the taxes incurred on the direct skip transfer (unless the decedent's will expressly waived this right of reimbursement), and

iii) the amount of the transfer for generation-skipping tax purposes should be the amount of the proceeds less the taxes incurred thereon.

iv) Unfortunately, Treas. Reg. §26.2662–1(c)(2)(iii) and Schedule R-1 of Form 706 adopt the position that, if the insurance proceeds exceed $250,000, the personal representative of the decedent-insured's estate should report the transfer on Schedule R-1 (and send a notice thereof to the insurer) but the insurer should pay the tax; if the proceeds are $250,000 or less, however, the personal representative would report the transfer on Schedule R and pay the tax from the decedent-insured's estate, and then seek reimbursement from the insurance company or the beneficiary. The rule exposes fiduciaries to potential liability if this distinction is overlooked and the fiduciary improperly pays — or fails to pay — the tax.

v) That liability would be avoided if the insurance were treated like a trust, thus clearly imposing the tax payment liability on the insurer (as "trustee").

(5) Finally for §2601 transition rule purposes, if the special election was made to treat pre-enactment directly skips to grandchildren as qualifying for the "Gallo" amendment ($2,000,000 grandchild exclusion), then "unless the grandchild otherwise directs by will, the estate of such grandchild shall be entitled to recover from the person receiving the property on the death of the grandchild any increase in Federal estate tax on the estate of the grandchild by reason of the preceding sentence."

(a) The special election has the effect of causing subject property to incur tax "as if [it had been paid] to the grandchild's estate," with tax liability being imposed under §2033 as to which no federal right of reimbursement otherwise exists.

(b) This provision calls for an incremental reimbursement right, like §2207A, but is not coordinated with §2207A to specify which right "goes first." Thus, the question is whether the increment in tax caused by §2044 property would be considered before, after, or in conjunction with the increase caused by inclusion of this grandchild exclusion property. Presumably a pro ration of the aggregate increase caused by both types of property is the proper result.

(c) The provision also does not appear to require the same "specific reference" dictated in §2603(b) to override its application. Quaere whether this was intentional or merely another legislative oversight. Given these problems with the provision, it is probably fortunate that it is unlikely that it often will apply.

D. Summary of state law: Silence generates what result?

1. The foregoing exegesis ought to illustrate that:

   a. There are a number of legitimate choices that might be made in determining the proper apportionment result.

   b. Conflicting results are dictated by the law in various jurisdictions in which the apportionment issues have been resolved.

   c. Federal laws lays its own layer of complexity over this area.

2. This portion of the outline illustrates the state law result if the estate plan does not address the apportionment issue.

   a. In some states the issues are (partially) resolved by statute.

   b. In a declining number of states only judicial authority exists.

   c. In a few states, on some issues, common law presumptions apply by default because state law is entirely silent.

   d. Many of the results in this segment are confused and inconsistent because the law is not uniform.

3. In a sense, although the intent is the exact opposite, the federal rules under §§2002 and 2205 are the starting point regarding state law apportionment.

a. Those provisions establish the fundamental proposition that the federal estate tax is not apportioned at all; it is a "burden on the residue" of the estate, as was true under common law.

b. But the Supreme Court established very early that federal law governs only to the extent state law regarding apportionment is not inconsistent. Riggs v. Del Drago, 317 U.S. 95 (1942).

   (1) If state law differs, the *state* law is supreme in this arena.

   (2) Thus, a state may alter the federal presumption and control the apportionment result.

c. If there is an established state dictate, especially if mandated under a state apportionment statute, that rule usually will apply unless the decedent clearly directs otherwise in an appropriate manner, whether by will, trust, or other document (as discussed in more detail below). The same is true about an alteration by settlement agreement in the wake of estate litigation, as painfully illustrated by In re Estate of Brabson, 752 A.2d 761 (D.C. App. Ct. 2000) (it likely is a precursor to malpractice litigation if a court has occasion to remark, as this one did, that "[i]t may even be that . . . former counsel did not detect the issue, and he evidently did not insist during negotiations that estate tax liability be allocated proportionately"), and less so but equally disappointingly in Houghland v. Lampton, 33 S.W.3d 536 (Ky. App. Ct. 2000) (family settlement of a prior estate led to a favored bequest in the decedent's will that could not be fully satisfied due to tax payment obligation, which was not apportioned in a manner that protected the favored bequest), in which will contest litigants eventually resolved their differences in negotiated compromises that failed to anticipate the tax payment consequences of their resolution, and therefore totally failed to articulate how taxes would be apportioned among their respective beneficial interests. The courts therefore defaulted to state law pro rata apportionment as if that was the dictated distribution under the decedents' articulated estate plans.

   (1) In determining whether a decedent has provided otherwise with sufficient specificity and clarity, the burden of proof normally is placed on those who challenge the state apportionment result.

   (2) A direction to pay all taxes from the residue of a decedent's estate typically will cause taxes on nonprobate property to be paid from the residue in an apportionment state, although cases like *In re* Estate of Kirby, 498 N.E.2d 64 (Ind. Ct. App. 1986) (will provision directing payment of all taxes was deemed to overcome statutory outside apportionment rule, notwithstanding lack of specific reference thereto), and Ferrone v. Soffes, 558 So. 2d 146 (Fla. Ct. App. 1990) (will

provision directing payment of all taxes from residue deemed *in*adequate to override statutory outside apportionment without specific reference), clearly show that a nonspecific direction is likely to cause litigation if it does not unambiguously identify and override state law.

(3) If not carefully drafted, a general tax payment direction in a will may be read to negate apportionment, if any, only within the probate estate, leaving any state outside apportionment statute to apply with respect to nonprobate assets. See Note, *Proposal for Apportionment of the Federal Estate Tax*, 30 IND. L.J. 217 (1955); Annot., *Construction and Application of Statutes Apportioning or Prorating Estate Taxes*, 71 A.L.R.3d 247 (1976); Annot., *Construction and Effect of Will Provisions Not Expressly Mentioning Payment of Death Taxes But Relied On As Affecting the Burden of Estate or Inheritance Taxes*, 70 A.L.R.3d 630 (1976); and Annot., *Construction and Effect of Will Provisions Expressly Relating to the Burden of Estate or Inheritance Taxes*. 69 A.L.R.3d 122 (1976).

4. Although any effort to summarize the law in the 50 states is subject to inaccuracies, Study #12 of the American College of Trust and Estate Counsel, dated August 2002, is available and relatively up to date. Errors due to interpretation and reporting communication glitches are inevitable, and even information once accurate gets stale, so:

   a. At the risk of stating the obvious, the following summaries are not certifiable; these laws change, cases are subject to differing interpretations, reports upon which reliance has been placed are only as good as the reporter and the interpretation thereof, and the reader is cautioned to use the following information only as an introduction to a detailed determination upon which reliance may be based.

   b. Please look for your state and, if the characterization of it appears to contain an error, a misreading, or lacks more current information, please contact me. I update the summaries, and . . . you know how that goes.

5. The importance of the following quick summary is to help illustrate why the material next below, dealing with conflict of laws and the need to affirmatively confront these issues in the estate planning and drafting process, is so important.

   a. As of 2002 22 states had adopted (and not subsequently repealed) either the original (1958) or revised (1964) Uniform Estate Tax Apportionment Act (most with some local modifications, a few so extensive that the Commissioners on Uniform State Laws do not claim parentage notwithstanding the Uniform Act was the template for the state statute) or the Uniform Probate Code (which, at §3-916, contains the same provisions as the Uniform Act):

Alaska (1958/UPC)	North Carolina (1964)
Colorado (UPC)	North Dakota (1964/UPC)
Hawaii (1964/UPC)	Oregon (1964)
Idaho (1964/UPC)	Rhode Island (1964)
Maine (UPC)	South Carolina (UPC)
Maryland (1964)	South Dakota (1958/UPC)
Minnesota (UPC)	Texas (1964)
Mississippi (1964)	Utah (UPC)
Montana (1958/UPC)	Vermont (1964)
New Hampshire (1958)	Washington (1964)
New Mexico (UPC)	Wyoming (1958)

   Arizona and Florida have otherwise adopted the UPC but do not appear to have retained §3-916.

   As of August 2003 a newly Revised Uniform Estate Tax Apportionment Act became available for future adoption. A summary of its changes is included in an Appendix (to avoid confusion with existing law),

   b. In addition to the above listed states, 16 other states can be identified that provide for *full* apportionment by statute:

Arkansas	District of Columbia	Louisiana	Oklahoma
California	Indiana	Nebraska	Tennessee
Connecticut	Kansas	Nevada	Virginia
Delaware	Kentucky	New York	West Virginia

   c. Missouri provides for *full* apportionment by judicial decision.

   d. Six states, Florida, Massachusetts, Michigan, New Jersey, Ohio, and Pennsylvania, provide for some form of *limited* apportionment by statute.

   e. Illinois provides for a form of *limited* apportionment by judicial decision.

   f. Finally, five jurisdictions may be identified that direct *against* apportionment

By Statute: Alabama, Georgia, and Iowa
By Judicial Decision: Arizona
By Statute and Judicial Decision: Wisconsin

6. Uniform Estate Tax Apportionment Act. Because the Uniform Estate Tax Apportionment Act is regarded by almost half of the states as the best form of statutory apportionment, it is appropriate to consider its major provisions briefly herein; problems with these provisions, and similar statutes or judicial rules, are considered in more detail in later segments of this outline. The Act establishes rules of four major types:

   a. Inside and Outside Apportionment. First, §2 of the Act establishes the basic proposition that all taxes imposed on an estate (which would include an inheritance tax only if it were a charge against the estate as a whole, which is not always the case) should be pro rated among all persons "interested in the decedent's gross estate for federal estate tax purposes."

      (1) This is a total inside and outside apportionment rule, applying a straight pro rata allocation based on the size of each interested individual's entitlement as compared to the size of the total estate for federal estate tax purposes.

      (2) Two special rules are designed to prevent unnecessary conflict with federal law.

         (a) One special rule, equitable apportionment, is found in §5(e) and may be illustrated by a simple example:

            i) Assume that a decedent's estate passes to the decedent's surviving spouse in a fashion that qualifies for the federal estate tax marital deduction but not (entirely) for the state wealth transfer tax marital deduction.

            ii) Under §5(e) of the Act, if apportionment of a state tax to the marital share would have the effect of reducing the federal estate tax marital deduction, the apportionment rule is not to apply, thus preserving the deduction without reduction.

            iii) A similar result would apply for charitable deduction purposes, if relevant.

            iv) This is likely to apply in those states that have yet to conform their law to the addition in 1981 of the unlimited marital deduction and the §2056(b)(7) qualified terminable interest property exception to the nondeductible terminable interest rules for federal estate tax marital deduction purposes.

v) For a detailed explanation of all the ramifications of §5(e), consult Scoles & Stephens, *The Proposed Uniform Estate Tax Apportionment Act*, 43 MINN L. REV. 907. 928-931 (1959).

(b) The other special rule is contained in §9, added in 1982, specifying that federal law will control if federal and state laws differ with respect to apportionment; it appears that the rationale for this provision was addition in 1981 of §2207A (as discussed above), calling for an incremental as opposed to a pro rata reimbursement of taxes, and the Act is simply specifying that the difference between §2207A and state law will be resolved in favor of federal law.

(3) A different rule of a special nature, deviating from the otherwise pervasive pro rata allocation of the tax burden, applies to temporal interests.

(a) Under §§5(b) and 6, the tax otherwise attributable to a life estate, term of years, or annuity is not apportioned thereto; instead, the tax is payable from corpus.

(b) This result is dictated even if the remainder interest qualifies for a deduction (most commonly the charitable deduction in a qualified charitable remainder trust); this allocation of taxes attributable to the temporal interest against the deductible remainder interest otherwise reduces the available deduction.

(c) This result also apparently applies notwithstanding the dictates of §5(e), as discussed above.

b. Alteration. The second major proposition established by the Act is how allocation under the Act may be altered; two methods are authorized:

(1) In unusual circumstances a court may alter the proportionate allocation of taxes, under authority of §3(b).

(2) A decedent may waive or alter the dictates of the Act under authority of §2, *but only* (as is expressly underscored by the comments to §2) *by* a provision in the decedent's *will.* See the discussion of *Estate of Roe* at page 120.

(3) Unfortunately, a specific reference to the apportionment rule being waived or altered is *not* required by the Act, meaning that broad,

nonspecific will provisions can raise important interpretative questions under the Act.

c. Entitlements. Third, the Act establishes the proper treatment of certain entitlements that affect the tax burden.

(1) For example, §5(c) provides that federal credits under §§2012 (credit for gift tax on pre-1977 transfers), 2013 (credit for tax on prior transfers), and 2014 (foreign death tax credit) inure to the proportionate benefit of all beneficiaries interested in the entire gross estate, rather than to the benefit of any particular recipient of property, such as the taker of the property that was previously taxed or subjected to a foreign death tax. Only the §2011 state death tax credit was apportioned to individual takers, and that credit was repealed after 2004.

(2) Alternatively, however, §§5(a), (b), and (d) provide that individual takers of interests included in the gross estate benefit from exemptions, deductions, and credits that relate specifically to "the purposes of the gift." "the relationship of any person to the decedent, "or the payment of any taxes attributable to the property.

(a) Thus, the charitable and marital deductions usually inure to the benefit of the recipient of property qualifying therefor, this being the rule of equitable apportionment (subject, as noted above, to the special rule applicable to temporal interests in property).

(b) For estates in which the prior §2039(c) or (e) $100,000 exemption for employee benefits is still applicable it is questionable whether the language or intent of this provision would allow the recipient of those death benefits to enjoy the exemption.

(c) Presumably the §2058 deduction for state death tax that took the place of the §2011 credit in 2005 also should benefit the individuals who bear that tax, as the §2011 credit also was apportioned.

(d) This rule also provides that the recipient is entitled to an adjustment in the allocation of tax to reflect any reduced rate of tax for state or other tax purposes, based on the relation of the recipient to the decedent (for example, if a state inheritance tax is paid out of the estate and recognizes more closely related individuals with a reduced rate of tax). Cf. In re Estate of Morris, 838 P.2d 402 (Mont. 1992) (estate distributable in two halves, one for relatives of decedent's predeceased spouse and one for decedent's relatives, under will that directed payment of all taxes from residue of estate before its division, which overcame state law and argument by decedent's relatives that estate should be divided before payment from each half of the taxes attributable to that half.

(e) For a strange application of the rule "giving" the benefit of a special tax rate to the beneficiary who "generated" it, see Estate of Garrison v. Garrison, 728 P.2d 535 (Or. App. Ct. 1986) (Oregon estate tax credit for a handicapped child inured solely to the child's benefit, not to the benefit of the entire estate, providing a larger effective share of the estate for the benefit of that child).

(f) If a recipient paid any tax that generated a §2011 credit for state death taxes before its repeal in 2005, it appeared that this credit also inured to the benefit of that individual, notwithstanding the difference in treatment of the allocation of the foreign death tax credit under §5(c); this would not be the case, however, if the state death tax had been paid by the decedent's estate. With §2058 Congress converted the state death tax credit into a deduction, that presumably will be allocable to those takers who paid state tax that generated the deduction.

(g) Quaere how §2015 is meant to be reflected. It allocates any §2011 or 2014 credits related to a future interest qualifying for §6163 deferral to that interest.

  i) The Act would say that the §2011 credit is properly allocated to that taker, but not the §2014 credit.

  ii) By virtue of the *Riggs* case, presumably state law would prevail in this conflict, although most decedents — if they thought about it — presumably would want the federal rule to apply.

(h) Under the unified federal wealth transfer tax computation procedure, the §2001(b) credit for gift taxes paid on property transferred during life should inure to the benefit to the estate as a whole if the transferred property is included in the gross estate for federal estate tax purposes (e.g., under §§2035 through 2038, 2041, or 2042).

  i) If the gift tax was paid by the decedent (including if the transfer was a net gift, with the donee's payment of gift tax treated as sale to the donee with the donor/decedent thereafter paying the tax), the credit for gift tax paid ought to inure to the benefit of the estate as a whole.

ii) In essence the estate has simply prepaid its wealth transfer taxes by virtue of the prior but included gift.

(i) Although the Act does not direct itself thereto, it also would appear that the unified credit is a benefit to the entire estate for apportionment among all takers.

d. Enforcement. Finally, the Act establishes mechanisms for enforcement of outside apportionment by providing for the "collection" of apportioned taxes.

(1) For example, §4(a) is a right of set off, allowing a personal representative to withhold property otherwise distributable to a beneficiary in that amount necessary to recoup the beneficiary's proportionate share of apportioned taxes.

(2) §4(a) also gives a right of recovery against any beneficiary whose share of taxes exceeds the amount of property the personal representative may withhold (if any).

(3) §8 gives a right to pursue enforcement of the §4(a) recovery in a foreign jurisdiction and grants a similar right to an out-of-state personal representative, by reciprocity.

(4) Finally, §7 recognizes that some beneficiaries of nonprobate assets will be immune to collection procedures; it specifies that the residue of the estate should pay any deficiency if a portion of tax cannot be recovered and, if the residue is exhausted, then the remaining beneficiaries will bear the balance of the deficiency in proportion to their existing tax allocations.

e. The Act itself applies to the estate of any decedent dying after a specified time following enactment, regardless of the time of execution of that decedent's estate plan and the unexpected effect the Act may have on the pattern of tax payment therein.

f. There is a final issue under the Uniform Act relating to the fiduciary's right to collect taxes apportioned to interested parties and the effect of a failure or inability to do so. §7 of the Act provides that:

(1) There is no duty to institute legal proceedings against any person interested in the estate to collect taxes apportioned to that person, prior to expiration of a specified period after determination of the tax.

(2) Further, any fiduciary who institutes a timely action to recover taxes is exonerated from liability if ultimately unable to collect.

(3) Implicit in this provision is the common law requirement that the fiduciary *must* assert any right of recovery for the benefit of the estate.

   (a) Just as the fiduciary must marshall all assets available to the estate.

   (b) the "right" to apportion taxes and the "authority" to recover is properly viewed as a requirement or duty. See Merchants Nat'l Bank v. Merchants Nat'l Bank, 62 N.E.2d 831 (Mass. 1945); Annot., *Remedies and Practice Under Estate Tax Apportionment Statutes,* 71 A.L.R.3d 371 (1976).

(4) With respect to assets located out of state, or taxable nonprobate assets received by a beneficiary who expends the property prior to a demand for apportionment or collection of the amount owed, this duty imposes an obligation that the fiduciary may be unable to satisfy.

(5) Assuming the fiduciary acted reasonably but was unable to collect, the burden then must fall somewhere, either on the estate or other beneficiaries.

   (a) If the burden fell on other takers, §2205 would give them a right of recovery exercisable against the residuary estate.

   (b) Under §7 of the Revised Uniform Act, the burden for those uncollected taxes is apportioned directly to the residue of the estate, presumably because this would be the end result in any event.

      i) Only if the residue is insufficient for payment is the uncollected amount reapportioned among the remaining persons originally subject to apportionment.

      ii) Under §7 of the original Uniform Act, those uncollected taxes are apportioned directly against the full class of individuals who must contribute in the first instance, permitting apportionment to apply immediately to uncollected taxes as well as to the original amount of tax initially determined.

   (c) Many state statutes appear to be silent on these issues, presumably meaning that general fiduciary principles will apply to the necessity to enforce apportionment and to the inability to recover from any individual who fails to pay an apportioned amount. See Annot., *Construction and Application of Statutes Apportioning or Prorating Estate Taxes*, 71 A.L.R.3d 247 (1976).

(d) In any event, it appears that inability to collect under a permitted proration entitlement generates a §166(d)(1) bad debt deduction to the individual(s) who ultimately suffer therefrom. See Rev. Rul. 69-411, 1969-2 C.B. 177.

7. Equitable Apportionment. If the estate plan is silent on the issue, state law determines whether equitable apportionment is available to any portion of the estate that qualifies for a deduction in the wealth transfer tax computation.

a. With respect to the computation of dispositions that qualify for the marital or charitable deductions, the law of the 50 states is reasonably clear.

(1) The vast majority of states embrace equitable apportionment, meaning that the deductible portion of an estate is exempt from apportionment of any portion of the taxes imposed on the estate.

(2) If the estate plan calls for a larger disposition than qualifies for a deduction, as under prior law when the marital deduction was not an unlimited entitlement or, under present practice, if the surviving spouse makes a disclaimer or only a partial qualifying election is made under §2056(b)(7)(B)(v), only the qualifying portion should be protected from apportionment.

b. At least to the extent noted, however, the following states do not appear to embrace equitable apportionment:

(1) No apportionment at all in Georgia and Wisconsin.

(2) No equitable apportionment for charitables in Arkansas.

(3) Equitable apportionment only for statutory intestate shares in Ohio.

(4) No equitable apportionment, but spousal share abates last, in Iowa.

(5) Equitable apportionment only for forced shares in Mississippi.

c. Much less certain is the treatment of distributions in satisfaction of a contractual entitlement, such as under a prenuptial agreement.

(1) If deductible under §2053 as a claim against the estate, these dispositions should be treated in the same fashion as a charitable or marital disposition.

(2) In this respect, §2043 makes certain property settlements at death deductible under §2053 if incident to a divorce and otherwise meeting the requirements of §2516.

(3) Otherwise, obligations incurred incident to divorce that are satisfied out of an estate at death but that are not deductible (along with pretermitted heir shares, which are not deductible), normally are ineligible for equitable apportionment.

(4) In a limited number of cases, claims satisfied at death that arise from a prenuptial agreement are treated as claims against the estate similar to claims of other creditors.

(a) Notwithstanding that they are not §2053 deductible like most creditors' claims, the recipient of property under the agreement is entitled to priority in payment, along with all other creditors.

(b) Because creditors are unaffected by the amount of taxes (except to the extent the estate is bankrupt, so that not all otherwise entitled claimants are satisfied) the claimant in these cases is effectively granted equitable apportionment. See, e.g., In re Cordier's Estate, 145 N.Y.S.2d 855 (Sur. Ct. 1955).

8. Apportionment of State Inheritance Taxes. Even in states that embrace full inside, outside, and equitable apportionment, state inheritance taxes imposed directly on individual recipients of a decedent's wealth usually are not subject to apportionment in a manner that equitably (re)allocates the burden. Thus, the decedent's estate plan must direct the estate to pay those taxes and, by virtue of this direction, cause the taxes to become an item subject to apportionment. In re Estate of Herz, 651 N.E.2d 1251 (N.Y. 1995) (German inheritance tax (Erbschaftsteuer), normally payable by estate beneficiary, deemed to be imposed on residue of decedent's estate by tax payment provision directing payment of all "estate, inheritance, and other death taxes"), is a good reminder that foreign inheritance taxes also ought to be considered if they will be relevant.

9. Apportionment of Fees and Expenses. Several cases dictate outside apportionment of fees and expenses of administration, but this sensible extension of the general theme has not been embraced widely. See Roe v. Farrell, 372 N.E.2d 662 (Ill. 1978); cited in Estate of Fender v. Fender, 422 N.E.2d 107 (Ill. App. Ct. 1981); Cloutier v. Lavoie, 177 N.E.2d 584 (Mass. 1961); In re Estate of McKitrick, 172 N.E.2d 197 (Prob. Ct. Ohio 1960).

a. The effect of fees and expenses and their apportionment can be significant in the marital and charitable deduction arena and is illustrated by several seemingly contradictory opinions addressing the proper treatment of estate income generated after a decedent's death in determining the allowable charitable or marital deduction for the decedent's estate.

10. To illustrate the importance of the following topic, consider an estate in year 2005 that qualifies for the marital deduction the smallest formula-determined amount needed to eliminate tax in the estate of the first spouse to die. Also assume that the estate incurs $50,000 of administration expenses that the §642(g) "swing item" election allows it to deduct for income tax or estate tax purposes. Finally, assume in the third column that these expenses are paid from estate income rather than from estate corpus as they are in the first two columns, and that they are deducted for income tax purposes in the middle two columns. For more detailed examples extrapolating from this illustration see Malin & Keller, *Planning for the allocation of administration expenses to income under* Hubert, 84 J. TAX'N 213 (1996).

	Pay with Corpus & Deduct on the Estate Tax Return	Pay with Corpus & Deduct on the Income Tax Return	Pay with Income & Deduct on the Income Tax Return	Pay with Income & Deduct on the Estate Tax Return
Gross estate	$2,000,000	$2,000,000	$2,000,000	$2,000,000
2053 deduct'ns	(50,000)	-------	------	(50,000)
marital bequest	(450,000)	(500,000)	(500,000)	(450,000)
taxable estate	1,500,000	1,500,000	1,500,000	1,500,000
bypass trust	1,500,000	1,450,000	1,500,000	1,550,000

a. The reason the bypass trust is smaller in the second column is because the swing item expenses were paid from corpus but not deducted for estate tax purposes, requiring a larger marital deduction to zero out taxes and leaving less property for the bypass trust. The bypass trust can be $1,500,000 in the third column even though the marital deduction is $500,000 because estate income was used to pay the expenses.

(1) As compared to the first column, the price to be paid in the third column for a bypass trust of $1,500,000 is a larger amount includible in the estate of the surviving spouse.

(2) Compared to the second column, however, there is no price to be paid for using estate income instead of estate corpus to pay the expenses if the §642(g) election is made for the income tax deduction rather than estate tax deduction for the $50,000 of expenses.

(3) As illustrated, the use of estate income therefore increases the amount includible in the estate of the surviving spouse or it increases the bypass trust with no other benefit, respectively. Contrary to governmental allegations, there is no improper or abusive double deduction benefit involved.

(4) Notice that the destination of estate income in the first two columns is not noted because there is no telling how income earned during estate

administration will be allocated, that being a function of state law, the terms of the document, and the nature of the various entitlements under the document (specific, general, and residuary). The important legal aspect regarding income earned during estate administration is that Treas. Reg. §20.2056(b)-5(f)(9) specifically provides that income earned during estate administration prior to distribution of marital deduction assets need not be made payable to the surviving spouse. Only a directed or authorized delay in distribution beyond a period reasonably required for administration would run afoul of the income entitlement requirements for marital deduction qualification.

b. If the result illustrated in the third column is authorized by state law or the applicable document, the income tax deduction will produce an immediate income tax savings but the corpus of the estate will not be reduced by the $50,000 of payments made from estate income. Thus, the bypass trust is $1,500,000 in the third column above and the only estate tax effect of the election to claim these deductions on the income tax return is a larger marital deduction (still needed to zero out the estate tax because no §2053 deduction is claimed for the swing items), and more wealth subject to inclusion in the surviving spouse's estate.

c. The Supreme Court in Commissioner v. Estate of Hubert, 520 U.S. 93 (1997), aff'g 63 F.3d 1083 (11th Cir. 1995), aff'g 101 T.C. 314 (1993) (a 14-2 reviewed opinion), held that the use of estate income to pay the estate administration expenses does not necessarily produce an improper result, effectively rejecting a government argument that

   (1) the marital bequest cannot be $500,000 in the right-hand column if the bypass trust is $1,500,000, so

   (2) the marital deduction must be reduced (that is, cannot be made larger by the amount of estate income used to pay the expenses).

d. In the recent past a number of contradictory opinions have addressed the proper treatment of using estate income generated after a decedent's death in determining in the allowable charitable or marital deduction for the decedent's estate. Although the Supreme Court spoke on this issue in *Hubert*, that decision is a plurality opinion that left a great deal to be desired and a number of issues to be resolved.

e. To illustrate the nature of the caselaw, consider the early case of Estate of Horne v. Commissioner, 91 T.C. 100 (1988), in which the decedent's estate paid fees to the decedent's personal representative, using income earned during the period of probate administration to avoid invading corpus of the estate's residue. The estate made the §642(g) election to claim a deduction for the payment of these fees under §212 for income tax purposes rather than claiming them as a §2053 expense of administration for estate tax purposes. The estate then claimed a charitable deduction for the full value of the residue of the estate, measured by the full amount left available for distribution — unreduced by the fees paid using postmortem estate income.

f. The Commissioner reduced the charitable deduction by the full amount of those fees, claiming a deficiency for the estate tax on that amount, which the Tax Court upheld. Essentially the question in *Horne* turned on the proper determination of the "residue" for state law purposes, and how much of it was both includible for federal estate tax purposes and then passed in a qualified manner to the charity for §2055 deduction purposes.

   (1) Citing Alston v. United States, 349 F.2d 87 (5th Cir. 1965), the Tax court determined in *Horne* that the estate was improperly trying to "deduct" postmortem income by paying fees from the income account to prevent reduction of the residue that otherwise would pass to the charity and would be deductible under §2055. The court reasoned that, had there been no income in the estate sufficient to pay those fees, the estate would have been forced to pay the personal representative's fees from the residue proper and would have had less available for distribution to the charity, resulting in a reduced deduction.

   (2) According to the Tax Court, the estate could not improve on this position by expending postmortem income. More importantly, as these cases have developed, state law required those expenses to be charged to corpus for fiduciary accounting purposes, meaning that the estate's payment from income was improper for state law purposes.

g. Estate of Richardson v. Commissioner, 89 T.C. 119 (1987), was quite different in result. The decedent's estate incurred interest on unpaid estate tax liabilities, which the estate paid and properly charged to income for fiduciary accounting purposes. The Commissioner attempted to reduce the estate's marital deduction by the amount of this charge, which the estate successfully resisted.

   (1) As explained by the Tax Court, payment of this interest as an administration expense using postmortem income earned by the residue of the estate did not diminish the amount passing to the surviving spouse for marital deduction purposes. Nor was the estate trying to increase the size of the deduction based on income earned postmortem.

   (2) Because payment of estate taxes was delayed, the estate was able to earn income while incurring interest payable to the government. The court properly held that neither the income earned nor the interest payable should alter the amount of marital deduction claimed for the corpus remaining after payment of all the debts, expenses, and taxes. The

government eventually conceded this question in Rev. Rul. 93-48, 1993-2 C.B. 270, discussed more fully shortly.

j. Estate of Street v. Commissioner, 56 T.C.M. (CCH) 774 (1988), *aff'd in part and rev'd in part,* 974 F.2d 723 (6th Cir. 1992), involved *both* interest on unpaid state and federal taxes and other administration expenses, all paid from postmortem estate income and claimed as a deduction on the estate's income tax return. The terms of the decedent's will and state law both denied exercise of any power or authority that would have the effect of preventing qualification for the marital deduction. But both state law and the document granted the personal representative discretion to allocate items of income or expense to either income or principal.

(1) The Tax Court followed *Richardson* (both cases turned on the law of Tennessee), meaning that the marital deduction was unreduced by these payments. That decision was affirmed with respect to the interest expense, but reversed with respect to the payment of administration expenses, as if these somehow differed (a notion that Justice O'Connor specifically rejected in her *Hubert* concurring opinion).

(2) According to the Tax Court, under State law expenses of the type involved in *Street* were a proper income expense for trust accounting purposes, which is how the personal representative charged these items for estate accounting purposes. Based on that finding, the Tax Court extended its prior ruling in *Richardson* to cover payment of both interest and expenses of administration.

(3) On appeal, however, the court distinguished the payment of administration expenses on the ground that they were deemed to accrue at the decedent's death and, as such, must be deemed to reduce the estate at death for purposes of determining the amount available for the marital deduction. Citing Treas. Reg. §20.2056(b)-4(a), the court held that administration expenses are different from interest paid postmortem on the basis of when each expenditure is deemed to accrue and concluded that income from the marital share that is used to pay the expenses that accrued at death should belong to the marital trust and, if diverted, must cause a reduction of the marital deduction. This distinction is silly and wrong and the Supreme Court opinion in *Hubert* did not embrace it.

k. At about the same time *Street* was decided on appeal, the Tax Court again held, in Estate of Young v. Commissioner, 64 T.C.M. (CCH) 770 (1992), that administration expenses paid with estate income do not reduce the amount of the marital deduction, essentially following the Tax Court's decision in *Street* prior to its reversal.

l. The Tax Court ultimately rendered two very strong opinions that most forcefully determined that the government was wrong entirely on this issue.

(1) Estate of Hubert v. Commissioner, 101 T.C. 314 (1993) (a 14-2 reviewed opinion), *aff'd*, 63 F.3d 1083 (11th Cir. 1995) (a 2-1 opinion), *aff'd*, 520 U.S. 93 (1997) (a 7-2 decision with no majority opinion, the plurality opinion representing the views of four Justices, a concurring opinion another three, and there being two dissenting opinions), rejected the distinction between expenses of administration and interest on deferred tax payments made by the appellate court in *Street* and by the government in Rev. Rul. 93-48.

(2) The Tax Court reaffirmed its position in *Richardson* and, the very next day, again held that the marital deduction should not be reduced by the use of postmortem income to pay administration expenses as authorized by state law or the terms of the document. Estate of Allen v. Commissioner, 101 T.C. 351 (1993). And, although one dissenting Tax Court opinion in *Hubert* claimed that "[t]he Tax Court stands virtually alone on this issue," the Tax court opinion was adopted virtually verbatim by the court on appeal and proved to be the winning position at the Supreme Court — indeed, the Tax Court majority opinion makes far better sense than any of the four Supreme Court opinions.

n. Of all the various Tax Court and other decisions and pronouncements, therefore, the Tax Court opinion in *Hubert* is the momentous decision because it reflects the best thinking and because it was a watershed modification of the Tax Court's analysis.

(1) Although a number of issues were involved in *Hubert*, flowing from a will contest settlement and delayed distribution of marital and charitable bequests, the crux of the case and the topic in common to the Tax Court majority and both dissenting opinions was the use of income to pay administration expenses.

(2) The Tax Court majority opinion determination that

(a) use of estate income to pay administration expenses was authorized.

(b) There is no merit to the distinction drawn by the appellate court in *Street* between administration expenses (such as fees paid to a personal representative or attorney) and interest on deferred tax payments, and

(c) The marital deduction issue properly analyzed involved Treas. Reg. §20.2056(b)-4(a), which (prior to its replacement following *Hubert*) was "merely a valuation provision which requires material limitations on the right to receive income to be taken into account when valuing the property interest passing to the surviving spouse."

(3) Although there was no similar discussion for charitable deduction purposes (and there is no corresponding regulation under §2055), the Supreme Court's opinion correctly stated that both deduction should require the same answer and the analysis under both sections is the same.

(4) According to the Tax Court, estate income has no effect on the estate's federal estate tax liability; it is not includible in the estate, it does not in any way increase the marital or charitable share, and it does not result in double deductions. Administration expenses properly allocated to income do not change the amount of the estate principal received by a spouse or charity and do not reduce the marital or charitable deductions.

11. Thus, if amounts charged to income are no greater than proper under state law and the governing document, there is no impact on either deduction. In this respect, Notice 97-63, 1997-47 I.R.B. 6, requested comments from interested observers and suggested a number of alternatives that the government ultimately decided to scrap, along with the material limitation approach in Treas. Reg. §20.2056-4(a). Thus, the proposed regulations released on December 15, 1998 and made final on December 3, 1999 (effective for estates of decedents who die after December 2, 1999) embrace a different approach.

a. The *concept* embraced by the regulation reflects a number of legitimate governmental concerns, noted in the preamble to the proposed regulation.

(1) One is that local law principal and income dictates should not govern the question of what is a proper charge to income earned during estate administration, because local law will vary between jurisdictions. Moreover, some states allow the relevant documents to override state law, making this notion "too malleable to protect the policies underlying the marital and charitable deductions." It also is fair to imagine that the government did not want to promulgate any kind of Federal principal and income mandate.

(2) The second conclusion reached by the drafter of the proposed regulation is that the prior test in Treas. Reg. §20.2056(b)-4(a) (penultimate sentence) of a "material" limitation on the deductible bequest was too complex and difficult to administer. That was confirmed by many of the comments to the various methods of determining materiality proposed in Notice 97-63 and elsewhere.

b. So the new regulation punts on materiality, it dodges state law principal and income determinations, and falls back to its own new-found distinction. The notion articulated was formally advocated by the New York State Bar Association comments to the Notice and turns on a distinction that was refined in the final version of the regulation and that still will require some refinement in practice but that probably could not be much further detailed in the regulation.

(1) One way to think about the concept is to conjure the difference between expenses of administration that are a proper charge to income and those that are more properly a charge to principal.

(a) By way of example, the *Hubert* estate administration was prolonged for an extensive period by two waves of litigation, during which time the estate incurred investment advisory fees much as would an on-going trust administration. (Indeed, if *Hubert* had involved an inter vivos trust these expenses might have been legitimate trust administration costs. It would be wise in this discussion to recognize that most everything said in the context of estate administration expenses will have a counterpart and spillover application in probate avoidance inter vivos trusts during their postmortem administration.) A normal fiduciary allocation of such a fee probably would charge income and principal equally, on the assumption that the investment advice benefited both income and remainder beneficiaries.

(b) Alternatively, the *Hubert* estate incurred the typical one-time expenses of estate administration relative to marshalling assets, appraising property, filing estate tax returns, paying creditors, and making final distribution. A typical estate administration would regard these as a proper charge to principal. Quaere the proper treatment of the *Hubert* costs of litigation that predominantly benefited the income beneficiary and were charged to estate income in that case. Consider below which characterization would apply to these.

(2) The new regulation only "sort of" embraces this kind of dichotomy. Because the government wants to avoid principal and income act distinctions, it instead developed two new terms: estate *management* expenses, and estate *transmission* expenses.

(a) <u>Estate management expenses</u> are like those properly charged to income: as defined in the regulation they are "incurred in connection with the *investment* of estate assets or with their *preservation* or *maintenance* during a reasonable period of administration" (emphasis added). Examples given are investment advisory fees, investment brokerage commissions, custodial fees, and interest paid.

(b) <u>Estate transmission expenses</u> are like those properly charged to principal: as defined in the regulation they are "expenses that would not have been incurred but for the decedent's death and the consequent necessity of *collecting* the decedent's assets, *paying* the decedent's debts and death taxes, and *distributing* the decedent's property to those who are entitled to receive it" (emphasis added). Examples given are probate fees, expenses incurred in a construction proceeding or will contest, appraisal fees, and fees paid to a personal representative and its attorney ("except to the extent . . . *specifically* related to investment, preservation, and maintenance of the assets" — emphasis added to stress that the regulation probably precludes unbundling or allocation of unspecified fees but may permit an on-going administration to bifurcate or distinguish between typical one-time administration costs and those that look more like recurring long-term fiduciary management fees).

i) The reference to construction or contest proceedings may be the regulation's way of reversing the result in *Hubert*, in which a big chunk of these items was paid from estate income because it was the income beneficiary who benefited from the litigation. Notice that the regulation refers to "expenses" and not specifically to "fees" in this statement, although it uses both terms elsewhere and in the same sentence. It appears that fees are just one form of expenses and that all litigation expenses are meant to be treated as transmission expenses. That may go too far but it appears to be the intent of the drafter.

ii) Also, quaere whether some portion of fees paid postmortem are entitled to estate management treatment. For example, at least to the extent of amounts paid for management by the same fiduciary who was managing the property premortem, it would seem that postmortem fees should be regarded as attributable to management and not transmission of the estate.

(A) In this light, fiduciaries might consider a fee schedule that actually imposes their fee on a segregated basis for postmortem work, including separate charges for clearly management functions such as income tax planning and investment, versus those that clearly relate to settlement or transmission of the estate. Similar distinctions might be made for attorney, accountant, and perhaps even appraisal fees.

(B) It has been noted that the fiduciary fee for a full estate administration might be very little more than the same fiduciary would charge for investment management and custodial services. If that is true, perhaps a good argument can be made that only the excess amount charged in the full management situation is for estate transmission — the base amount would appear to be management expense in all cases.

(3) At any rate, there is some degree of oversimplification in the regulation's bifurcation, as illustrated by the estate litigation in *Hubert* that was in large part directed at preserving the income interest of the surviving spouse and, as such, the costs were a proper charge to some degree against the income account. But as illustrations, the estate transmission expense items listed as they relate to a normal short-term fiduciary administration (of an estate or probate avoidance trust) all entail the limited function of marshalling the decedent's wealth, figuring out what it is worth, to whom it passes, how to pay taxes or debts and expenses, and finally make distribution.

(a) All these fit easily within the rubric of items incurred because the decedent died. Historically those have been allocated to the principal of the residue of an estate. It remains to be seen whether the regulation will be interpreted to preclude more fine distinctions — a form of rough but simple justice.

(b) The distinction between management and transmission expenses was more significant in the proposed regulation and in practical administration it may not make a great deal of difference, as this discussion and the spreadsheet illustration will reveal.

c. Now the concept in full: For deduction purposes, the value of any deductible property interest "shall be reduced by the amount of estate *transmission* expenses and paid from the [deductible] share." Which is to say that the normal one-time kinds of expenses of administration incurred in simple estate administration reduce the marital or charitable deductions to the extent those expenses are paid from that portion of the estate that passes to the surviving spouse or to charity.

(1) Because expenses of administration normally are paid from the estate residue, it is easiest to comprehend what the government envisions by considering a residuary marital or charitable bequest. It does not matter whether estate income or principal is used to pay these estate transmission expenses: *transmission* expenses that reduce the estate available for the spouse or charity reduce the deduction, regardless of whether income or principal is the source from which they are paid.

(2) On the other hand, the marital deduction or charitable deduction shall be reduced by estate *management* expenses in two circumstances. One is quite proper, the other quite the opposite.

(a) The one that makes sense is that management expenses reduce the deduction *to the extent* those expenses are "attributable to" property that passed to a beneficiary *other than* the spouse or charity, but are paid from the deductible property interest.

i) The proposed regulation added a requirement that the other beneficiary was entitled to the income produced by the property passing to that other beneficiary. Which was to say that these expenses to manage the estate reduced the marital deduction or charitable deduction only if the expenses were incurred to produce income that passed with a nondeductible bequest, but the management expenses are borne by the deductible portion of the estate. That distinction was removed and now it would appear that this implicit connection between management expenses and income generation has been more formally severed.

ii) Oddly enough, and inconsistent with this change, the final regulation added an example (Treas. Reg. §20.2056(b)-4(d)(5) *Example 7*) stating that, if a pecuniary marital deduction bequest is not entitled (under state law or the document) to *any* income earned by the estate, then the use of income to pay transmission expenses is not cause to reduce the marital deduction. Quaere whether this should have been management expenses and whether it reveals that income entitlement remains a viable lodestar in this paradigm.

iii) The preamble to the final regulation contained the following passage: "the final regulations illustrate the application of these rules to pecuniary bequests to the surviving spouse. If, under the terms of the governing instrument or applicable local law, the recipient of a pecuniary bequest is not entitled to income earned prior to distribution . . . the amount of the property passing to the surviving spouse or charity for which a marital or charitable deduction is allowable will not be reduced even if estate transmission or estate management expenses are paid out of the income earned by assets that will be used to satisfy the pecuniary bequest." No provision in the regulation proper appears to actually establish such a rule at all for charitable deduction purposes and the only example for marital deduction purposes is limited to transmission expenses, so it may be that this "principle" stated in the preamble is less than reliable.

(b) The second aspect of the management expense portion of the rule is quite controversial. An item of history may help to appreciate why. The swing item election — whether to deduct these various expenses of administration on the estate tax return (Form 706) or the estate's income tax return (Form 1041) — was not a factor in the proposed version of this regulation: there was none of the "double deduction" nonsense that the *Hubert* opinion properly dismissed, *except* in one tiny (but, again, controversial) respect.

i) The proposed regulation addressed the problem illustrated by Estate of Bahr v. Commissioner, 68 T.C. 74 (1977), *acq.*, 1978-1 C.B. 1, by stating that, if the administration expense deduction was claimed under §2053 on the estate tax return, and that deduction reduced taxes and thereby increased the residue, and the residue passed in a deductible manner to the spouse or a charity, that increase in the residue could not be reflected in the tax calculation.

ii) This phenomenon informed an illustration that related *solely* to estate management expenses. In this illustration tax payment is deferred and interest incurred on a loan is deductible under §2053, which reduces the estate tax, which increases the residue passing to the surviving spouse or a qualified charity, which creates a larger deduction, again increases the residue, and further increases the deduction. Thus, with a §2053 deduction that remains constant, imagine:

$5,000,000	gross estate
2,000,000	specific bequests
2,000,000	residuary charitable bequest
1,000,000	assumed tax on $3 million taxable estate
50,000	expenses — paid from income

	First Trial Calculation	Second Trial Calculation	Third Trial Calculation
Gross Estate	5,000,000	5,000,000	5,000,000
§2053 deduction	(50,000)	(50,000)	(50,000)
§2055 deduction	(2,000,000)	(2,025,000)	(2,040,000)
taxable estate	2,950,000	2,925,000	2,910,000
tax on new taxable estate amount (assume)	975,000	960,000	even less tax than before

iii) Commentary allegedly attacked that rule and, instead of the government resisting the ability of taxpayers to leverage postmortem administration expense deductions into an ever-increasing marital or charitable deduction, it "capitulated" into a very more egregious provision in the final regulation. Not subject to comment and of major significance, this provision quite possibly is invalid (although any challenge is likely to be a hard fought and expensive battle).

(c) In lieu of the limited but questionable provision in the proposed regulation, Treas. Reg. §§20.2055-3(d)(3) and 20.2056(b)-4(d)(3) adopt a hugely expansive and even more controversial dictate that estate management expenses that are attributable to and paid from the deductible portion (a clarification confirmed by examining Treas. Reg. §20.2056(b)-4(d)(5) *Example 3*) and deducted under §2053 reduce the allowable marital or charitable deduction dollar for dollar, under the questionable authority of §2056(b)(9).

(3) The net result is that management expenses reduce the deduction

(a) to the extent they are paid from the deductible portion but are attributable to nondeductible sources or

(b) to the extent attributable to deductible sources and actually claimed for estate tax (versus income tax) purposes.

(c) Transmission expenses reduce the deduction to the extent paid from a deductible portion.

(4) Treas. Reg. §20.2056(b)-4(d)(5) *Example 4* illustrates the government's approach. The facts are: a gross estate of $3,000,000, of which $150,000 is life insurance payable to a child. The decedent's unified credit was exhausted inter vivos and the documents provide that the child shall incur any tax on the insurance proceeds. The balance of the estate passes to the surviving spouse and qualifies for the marital deduction. Management expenses are $150,000, all attributable to and paid from the marital bequest. They do not constitute a reduction to the deduction because they are entirely allocable to the deductible portion. Not stated in the example, presumably these expenses are paid from the marital portion of the estate — there is no other wealth involved from which to make payment. Calculation of taxes without application of the regulation's new rule is:

gross estate	3,000,000
marital deduction	(2,850,000)
§2053 deduction	(150,000)
taxable estate	0

The rub, according to the regulation itself, is that: "claiming a marital deduction of $2,850,000 would be taking a deduction for the same $150,000 in property under both sections 2053 and 2056 and would shield from estate taxes the $150,000 in insurance proceeds passing to the decedent's child."

(a) An estate tax will be incurred by the estate here because the marital deduction is reduced by the $150,000 of §2053 deductions claimed, but the regulation does not state whether that tax will be paid by the child or from the probate estate passing to the surviving spouse. If the latter is the case a circular whirlpool calculation would be created as marital deduction was lost for the amount of taxes paid by the marital bequest, causing more tax to be incurred and paid, causing more deduction to be lost, ad nauseum.

(b) The government's intended resolution is to claim the $150,000 of deductions on the estate's income tax return — denying the child the benefit of those estate tax deductions. Unknown to most observers, this is the exact opposite of what the government wanted to happen in *Hubert*: it offered to settle that case for zero dollars of estate tax liability if the taxpayer would simply flip its income tax deductions off the estate's income tax return and take them for estate tax purposes. This objective is particularly spurious in the regulation, given that administration expenses generated by deductible portions of estates have produced estate tax deductions that have forever benefited nondeductible portions of estates.

(c) This is true merely because the deductible portion (being nontaxable) never benefits from expenses that are deductible if applicable local law embraces the concept of equitable apportionment (which is the law virtually everywhere): if taxes incurred by an estate are regarded as the obligation of the portion of the estate that spawned those taxes, then of necessity deductions that reduce those taxes "belong to" or "benefit" the nondeductible portions of the estate. So in essence what this regulation is attempting to accomplish is a change of many decades of established estate tax law.

(5) The regulation wants to accomplish that change by applying §2056(b)(9), which arguably cannot apply to management expenses because the reference in §2056(b)(9) is to "an interest in property" that is being deducted more than once and these expenses — generated postmortem and basically ignored in the estate tax calculation (if paid pro rata) — are not "an interest in property" as that term is used in the Code. At least not as that concept is interpreted by these regulations, which regard management expenses as outside the estate tax valuation regime.

(6) There is another, more fundamental, matter involving error in these final regulations. Treas. Reg. §20.2056(b)-4(d)(5) *Example 4* reveals a fundamental inconsistency of the regulations' approach to management expenses, and in doing so reveals the heart of the government's objection. In the process it also shows that the regulation position regarding §2056(b)(9) is improper. It seems clear that the government views management expenses as a proper charge to the deductible portion because they are incurred to generate income or preserve and manage that portion, which is a right concept: these expenses will be incurred for the life of the deductible portion and they do not enter into the calculation of the estate tax value of the deductible portion. That notion (albeit not economically sound) is consistent with decades of estate tax administration. Any other approach would raise the same kind of administrative and valuation impossibility that *Hubert* itself found it could not address.

(a) That notion about the nature of management expenses is, however, inconsistent with saying that a double deduction impropriety is involved if a §2053 deduction is claimed for those same expenses: how can it be that items that are outside the estate tax valuation of the deductible portion — they are not really an estate tax consideration at all — become an element of value that is included in the estate tax calculation and represent an improper double deduction just because the expense is deducted under §2053?

(b) In reality, the problem being addressed is §2053 itself, which is inconsistent with the very nature of the estate tax, which basically takes a snapshot at the date of death to determine what is includible and its value, and what is deductible. Yet postmortem expenses constitute a deduction, even those that have nothing to do with administration of the estate in the transmission expense sense — even management expenses that would have been incurred even if the decedent had not died. If the system worked properly, either postmortem income and postmortem expenses would all be considered in the determination of value at the date of death or, because that is a fundamental administrative impossibility, neither postmortem income nor postmortem expenses (particularly management expenses) would be considered.

(c) Treas. Reg. §20.2056(b)-4(d)(5) *Example 7* confirms that the lack of a postmortem income entitlement does not alter the estate tax value of the deductible bequest to the surviving spouse — which itself is inconsistent with Treas. Reg. §20.2056(b)-4(d)(5) *Example 4* suggesting that postmortem expenses do alter the estate tax treatment. Consistency would say that Treas. Reg. §20.2056(b)-

4(d)(5) *Example 7* is wrong too, but it is favorable to taxpayers who make pecuniary bequests to a surviving spouse that do not carry income or interest under state law and is not likely to be challenged.

(7) Notice the improbability of what all this does, in terms of timing. If the wealth transfer tax system is meant to employ a snapshot principle, this regulation makes it nearly *impossible* to know the marital or charitable deduction until estate transmission (and certain estate management) expenses are known — *unless* those expenses cannot be paid from a deductible portion of the estate or are not deducted on the estate tax return.

(a) Quaere what would happen if the document precluded payment from the "wrong" source but the fiduciary improperly paid from that prohibited source anyway. Presumably the result would be to redress the fiduciary breach and not to adjust the deduction.

(b) Also notice, however, that the document probably should *not* dictate or prohibit certain sources for payment. As the illustration in the spreadsheet below reveals, postmortem administration that generates a reduction in the deduction may be the *best* result! Similarly, although *Example 6* in the regulation illustrates that drafting a bypass trust by reference to the applicable exclusion amount in a vacuum is not a wise technique, it probably is *not* desirable to draft formula marital deduction bequests that will self adjust to always produce a zero tax result, based in this context on whether more than a pro rata portion of management expenses are paid from the deductible portion.

d. Because estate transmission expenses include taxes, some examples in the regulation illustrate that an estate with less marital or charitable deduction than needed to reduce taxes to zero will require an interrelated computation if the deductible portion incurs those taxes. That is not a change, but it illustrates that residuary marital and charitable bequests pose problems that might best be avoided by falling back to traditional preresiduary deductible bequests, even in larger estates. And because the §663(c) separate share rule regulations as applied to estates create the need to account for a pecuniary bequest in the same "rolling fraction" manner currently required in fractional marital or charitable bequest situations, it may pay to reassess entirely the parameters of marital funding and strongly consider using the pick-and-choose fractional approach.

e. In the spreadsheet illustration that follows the assumption in the last two columns is that estate transmission as well as estate management expenses are paid — using income — from both the marital and nonmarital portions of the estate, pro rata. Payment of transmission expenses from the marital reduces the marital deduction for estate tax calculation purposes. In addition, the first and last columns posit that the management expenses are deducted under §2053, causing a reduction of the marital deduction for the amount of those expenses attributable to the marital portion.

(1) Notice that, although the marital deduction is reduced, the marital bequest itself is not changed — neither increased to maintain a zero tax result nor decreased to match the amount of the deduction. This is a function of the formula marital deduction bequest used, which in most drafters' forms otherwise might ratchet the marital bequest to be larger if the deduction is reduced by virtue of these regulations. Unless the desirable result illustrated in the fourth column below is to be avoided, however, this self-adjusting formula may *not* be desirable.

(2) Also notice that estate tax incurred because the marital deduction is reduced is paid from the bypass trust, essentially to avoid further reducing the marital deduction by virtue of payment of tax from the marital share. It may pay to push a pencil to see if that further reduction in the deduction actually pays dividends over both lives.

(3) Finally, the assumption is that there is enough income in the estate administration to pay all the expenses from income, and that the spouse dies after just the first year's income is received and taxed to the two trusts. All figures reflect the 2000 and 2001 unified credit and, notwithstanding the assumption of deaths that close together, no effort has been made to factor into the calculation either the surviving spouse's overlife or the income yield assumptions to make a §2013 credit calculation.

(4) The final result illustrated nevertheless requires the estate administrator to consider how to apportion payment of the expenses, whether to pay using estate income or principal, and whether to deduct expenses for estate tax or estate income tax purposes. To determine which approach is preferable, compare the difference in total wealth on the bottom line after all the anticipated income and wealth transfer tax. By all accounts it appears that the last column produces the best results, even with the regulation reflected and the marital deduction reduced: the taxes saved over both estates is greater than the difference in total wealth.

f. If these conclusions are valid, then it would seem that, by all means, the document should leave all options open by *authorizing* payment from estate income or principal. without distinction between estate management and estate transmission expenses, and authorize deduction on either return.

(1) Added considerations include whether to adjust the marital bequest to reflect the reduction — it would appear that not adjusting is the better

result economically — and whether to make any adjustment to reflect all the fiduciary decisions being made that affect the entitlement of the marital and bypass beneficiaries.

(2) Note in particular that the authority alone will not pose a threat to the marital or charitable deduction — it is the source of actual payment and deduction that appear to be the key.

(3) Also quaere, however, how the government's administration of this result will work if estate administration is not complete before a closing letter is set to issue and expenses of administration might be paid in a manner that should reduce the deduction: will some form of settlement agreement or condition on the closing letter be imposed, or in that context will the authority alone suffice to preclude the deduction? All these kinds of issues remain to be resolved and the regulation gives no indication of these practical consequences.

	Pay All with Bypass Corpus and Deduct on Estate Tax Form 706	Pay All with Bypass Corpus and Deduct on Income Tax Form 1041	Pay All Pro Rata with Income and Deduct on Income Tax Form 1041	Pay All Pro Rata with Income and Deduct on Estate Tax Form 706
Gross Estate	3,000,000	3,000,000	3,000,000	3,000,000
2005 Applicable Credit Amount	(1,500,000)	(1,500,000)	(1,500,000)	(1,500,000)
Transmission Expense (ETE)	(150,000)	(150,000)	(150,000)	(150,000)
Management Expense (EME)	(50,000)	(50,000)	(50,000)	(50,000)
§2053 Deduction	(200,000)	0	0	(200,000)
Formula Optimum Marital	(1,300,000)	(1,500,000)	(1,500,000)	(1,300,000)
Actual Marital Deduction	(1,276,786)	(1,500,000)	(1,425,000)	(1,213,333)
Taxable Estate	1,523,214	1,500,000	1,575,000	1,586,667
Bypass Trust Before Tax	1,500,000	1,300,000	1,500,000	1,700,000
Tax on Bypass Trust	10,446	0	33,750	39,000
Bypass Trust After Tax	1,489,554	1,300,000	1,466,250	1,661,000
Remaining Income	200,000	200,000	0	0
Marital Income	92,857	107,143	0	0
Marital Income Tax (at 35%)	32,500	0	0	30,333
Net Marital Income	60,357	107,143	0	(30,333)
Total Marital Trust	1,360,357	1,607,143	1,500,000	1,269,667
Bypass Income	107,143	92,857	0	0
Bypass Income Tax (at 35%)	37,500	0	0	39,667
Net Bypass Income	69,643	92,857	0	(39,667)
Total Bypass Trust	1,559,196	1,392,857	1,466,250	1,621,333
Total Wealth	**2,919,554**	**3,000,000**	**2,966,250**	**2,891,000**
Tax When Spouse Dies	147,161	242,500	190,000	106,350
Total Wealth After All Tax	**2,772,393**	**2,757,500**	**2,776,250**	**2,784,650**

Note that the first column entails loss of marital deduction because of prohibited §2053 deduction of the marital share of the EME. The third column entails loss of marital deduction because of payment of the ETE pro rata from the marital portion. The fourth column entails loss of marital deduction for both reasons.

All calculations assume death in 2005, a formula provision that does not self adjust to increase the marital bequest to the extent the marital deduction is reduced under the *Hubert* regulation, and no §2013 credit.

Pro rations are based on size of the marital and bypass trusts before tax payment from the bypass, to avoid circular calculation. Tax paid from the bypass trust avoids further reduction of the marital deduction.

12. Apportionment of Interest and Penalties. Many state statutes, including the Uniform and the Revised Uniform Acts, dictate apportionment of interest and penalties assessed along with the underlying taxes imposed on an estate. See Rev. Rul. 80-159, 1980-1C.B. 206, and Estate of Simpson v. White, 67 Cal. Rptr. 2d 361 (Ct. Ct. App. 1997) (citing another version of this author's work). In addition, §2207A(d) and 2207B(d) specifically dictate this result for federal tax purposes. Unfortunately, this is not a universal rule and, in some states, these added items are not chargeable in the same manner as the underlying tax. See, e.g., Estate of Richardson v. Commissioner, 89 T.C. 1193 (1987); and Annot., *Construction and Application of Statutes Apportioning or Prorating Estate Taxes*, 71 A.L.R.3d 247 (1976). As illustrated by Estate of Whittle v. Commissioner, 97 T.C. 362 (1991), aff'd, 93-1 U.S. Tax Cas. (CCH) ¶60,141 (7th Cir. 1993), and In re Estate of Detlefs, 418 N.W.2d 571 (Neb. 1988), interest on estate tax is not the same as the tax itself and may be chargeable in a different manner unless the document or applicable state or federal law specifically provide for it.

13. Apportionment of Credits. Consistent treatment also is lacking with respect to a number of other important issues that often are ignored or only partially addressed under state law. For example, only partially recognized under the Uniform Acts and ignored by many states entirely is the effect of credits.

14. Computing Various Entitlements. A related question is the order in which shares, taxes, and allocations are to be determined.

    a. For example, federal tax is computed after all deductions are reflected but the discussion above about whether the marital share is computed before or after payment of those taxes illustrates that it is not always clear how computations interrelate for purposes of federal tax, state tax, marital and other "forced" shares, and division of the "residue."

    b. Thus, for example, the question may arise whether state law provides that federal taxes (reflecting all credits) are to be paid from or charged against the available assets, then any division into shares made, followed by computation and payment of state death taxes based on the various shares?

        (1) An alternative would be to compute and subtract the federal and state taxes based on the same amount in the estate, then divide the balance as provided in the estate plan.

        (2) A third alternative mechanism would be to divide the estate according to decedent's estate plan, then compute and subtract the federal and state taxes based on the size of those shares.

c. Different approaches may be dictated in different situations:

(1) For example, the third alternative basically describes the operation of equitable apportionment whereby a deductible share, such as a marital or charitable deduction bequest, is computed before taxes while the balance of the estate is divided after payment of taxes.

(2) As indicated earlier in discussing the issue of equitable apportionment, there is no uniformity of approach on these issues; state law must be consulted to determine the "standard" approach and then the estate plan should be drafted with any desired changes clearly specified (that is, a decedent can change equitable apportionment by changing the marital share from a gross to a net estate division).

15. Apportionment Versus Reimbursement. Also note that, procedurally, the order of payment of the tax and the apportionment and collection thereof may differ between jurisdictions.

a. In some states it may be necessary to pay all taxes before their allocation and collection, this being the procedure that §§2206, 2207, 2207A, and 2207B appear to anticipate (in terms of their right of reimbursement for taxes already paid).

b. Other states (apparently including states that have adopted the Uniform Acts) permit apportionment prior to payment, presumably improving liquidity by allowing (requiring?) interested parties to contribute liquid assets rather than require sale of estate assets, followed by reimbursement.

16. Apportionment to Nonprobate Assets. It is not universally established that a decedent's will may apportion taxes to nonprobate assets in the absence of, or contrary to, state law.

a. If state law calls for apportionment of taxes, a decedent's will may negate that local apportionment rule by calling for payment of all taxes out of the probate estate (assuming the decedent's intent is clear).

b. If state law contains no apportionment authority, or if state law expressly directs against apportionment, the issue is whether a decedent may affirmatively direct, by a provision in a will, that taxes will be allocated to nonprobate assets.

(1) This is a particularly acute issue if the nonprobate disposition is an irrevocable transfer as to which the decedent relinquished all rights of control and in which the decedent included no special payment directive. Moreover, if the direction is not valid under local law but the

beneficiary nevertheless accedes and does contribute, the question answered in the negative by Private Letter Ruling 200027016 — is a gift made when the taker of nonprobate property contributes to the tax payment as obligated under state law — may turn the other way if there is no state law power to compel those nonprobate takers to contribute but they do so nevertheless.

(2) If a decedent's transfer is incomplete for federal tax purposes (or otherwise was subject to inclusion), the suggestion is that there is a correspondingly sufficient nexus to permit the decedent to exert control by means of a testamentary apportionment provision. Thus, for example, with respect to §§2037-2039 and 2701(d), as to which no federal reimbursement provision exists, may a decedent's will apportion a share of the total taxes to the assets subject thereto?

c. A similar but perhaps less severe issue is whether a decedent may direct a different form of apportionment than that permitted or directed under state law, again in situations in which a will otherwise would be regarded as ineffective or alter or amend an irrevocable nonprobate transfer. For example, if Congress were to amend §2042 to cause inclusion of insurance owned by and payable to an irrevocable insurance trust, §2206, would allow reimbursement of the pro rata share of taxes attributable thereto, but could a decedent's will call for an incremental reimbursement or direct the trust to pay those taxes directly?

d. Although the authorities in this respect are not uniform, the better supported position appears to be that a sufficient nexus to require inclusion for federal estate tax purposes is a sufficient nexus to permit the decedent to require apportionment or to direct a different form of apportionment than that specified under state law. See, e.g., United States v. Goodson, 253 F.2d 900 (8th Cir. 1958); and in re King, 22 N.Y. 2d 456, 239 N.E.2d 875 (1968); but see Warfield v. Merchants Nat'l Bank, 147 N.E.2d 809 (Sup. Jud. Ct. Mass. 1958) (citing but refusing to follow *Goodson*). It might be argued that the maximum amount of tax that could be collected from such property under §6324(a)(2) (an amount equal to the asset's federal estate tax value) should be the only limitation on the decedent's power to alter state or federal apportionment rules.

17. <u>Apportionment to Temporal Interests</u>. The law is relatively clear regarding apportionment of taxes allocable to life estates and terms of years but significant variations exist relative to taxes attributable to an annuity.

a. Section 6 of the Uniform and the Revised Uniform Acts is representative of the law in most states, specifying that taxes attributable to a life estate or term of years are to be paid out of corpus, not charged against the temporal interest. See, e.g., National Newark & Essex Bank v. Hart, 309 A.2d 512 (Me. 1973); In re Williamson's Estate, 229 P.2d 312 (Wash. 1951); Estate of Jack v. Commissioner, 8 T.C. 272 (1947) (involving charitable remainder and reduction of charitable deduction by virtue of apportionment rule).

(1) Although this rule appears inequitable on its face, it actually is sensible, given the fact that reduction of corpus for the payment of taxes correspondingly reduces income to be earned thereon and effectively amortizes the tax allocable to the income interest.

(2) The rule also is administratively attractive because the present interest income beneficiary need not contribute toward payment of taxes that might exceed any income received at the time of tax payment.

b. With respect to annuities, a different situation is presented because the annuity may be a guaranteed amount, payable from corpus to the extent annual income is insufficient. Thus, a reduction of corpus in payment of taxes allocable to the annuity may not cause a reduction in the amount of the annuity.

(1) More importantly, many annuities precede a qualified charitable remainder in situations in which taxes attributable to the lead annuity are the only taxes attributable to the entire property (because the remainder qualifies for the charitable deduction); payment from corpus not only is inequitable but also will reduce the charitable deduction under §2055(c). See, e.g., Estate of Leach v. Commissioner, 82 T.C. 952 (1984); Rev. Rul. 82-128, 1982-2 C.B.71.

(a) Under the present actuarial and valuation tables, charitable remainder annuity trusts are more attractive in terms of the deduction generated. Thus, more annuity trusts than unitrusts are likely to be drafted.

(b) Unlike the annuity (which is fixed in amount regardless of the income of the trust), the unitrust interest more closely resembles an income interest (and, in fact, it may be geared to the annual income earned by the trust), making the allocation rule seem more equitable (although it still does not protect the charitable deduction). Technical Advice Memorandum 9419006 illustrates that a reduction of corpus correspondingly reduces future unitrust payments that are a percentage of the annually determined fair market value of the trust.

(2) Notwithstanding reasons suggestions that annuities deserve different treatment than other term interests, the law in most states follows the

Uniform Acts' approach for term interests in general, causing all taxes to be paid from corpus.

(a) The comments to §6 of both Uniform Acts state that this result is mandated by the fact that no other practical solution exists.

(b) Nevertheless, at least one state (New York) has, by statute, dictated that the proper treatment is to pay taxes allocable to the annuity interest from corpus and then reissue the annuity to pay a smaller annual amount as a result thereof. See Annot., *Construction and Application of Statutes Apportioning or Prorating Estate Taxes*, 71 A.L.R.3d 247 at §19(b) (1976) and Annot., *Liability of Income Beneficiary of Trust for Proportionate Share of Estate or Inheritance Tax in Absence of Specific Direction in Statue, Will or Other Instrument*, 67 A.L.R.3d 273 at §4(d) (1975).

(c) Even in New York, however, there is authority that the payor of the annuity is not liable for payment of the tax. See In re Bissell's Will, 130 N.Y.S.2d 103 (A.D. 1954), although this is related to the New York position with respect to the liability of an insurer for payment of taxes allocable to proceeds held by the company (as discussed above).

(d) There is some support for the proposition that the annuitant should be charged with the full amount of taxes allocable to the annuity, regardless of the fact that this individual may not have liquid assets with which to pay that portion of the taxes. See Carpenter v. Carpenter, 267 S.W.2d 632 (Mo. 1954).

(e) One final alternative is recommended by Scoles & Stephens, *The Proposed Uniform Estate Tax Apportionment Act*, 43 MINN. L. REV. 907, 928, (1959), that taxes be paid from the underlying corpus but be recovered by an amortization assessment against the annuitant over the life of the annuity itself. This approach is justified on the grounds that the risk of an early termination of the annuity, prior to full collection of total taxes allocable thereto, is matched by the benefit to the remainder beneficiaries if the annuity does in fact so terminate.

(3) In drafting an estate plan, apportionment of the tax burden with respect to annuities could be addressed, even though the vast majority of plans do not. Prior to 1984 this may have been an acceptable default in drafting, but the apportionment issue relating to annuities is extraordinarily important because of the repeal of all §2039 exclusions for employee benefits.

(a) The issue can be avoided if the benefit qualifies for the normal estate tax marital deduction, if state law recognizes equitable apportionment.

(b) Similarly, with respect to employee benefit payments made in a lump sum, no serious issue is raised because the recipient has the funds to make immediate payment.

(c) Otherwise, because federal law does not grant a right of reimbursement, this likely will be a significant issue because of the amount of wealth tied up in employee benefit plans.

(4) If the standard rule for apportionment is not followed with respect to employee benefit annuities, a number of issues are created under the law relating to qualified employee benefit plans.

(a) For example, if apportionment is applied against a qualified survivor's annuity, as dictated by §401(a)(11), to the extent the annuity does not qualify for the §2056(b)(7) marital deduction (for example, because the automatic election is reversed), would apportionment somehow violate either the spirit or the letter of §401(a)(11)?

(b) More directly, with respect to any beneficiary, does the plan permit or even address apportionment, and without authorization in the plan or under federal law is apportionment even possible? Certainly it would affect the plan's assumptions regarding time of payments and its determination of liquidity needs.

(c) Do the anti-alienation or anti-assignment rules preclude apportionment against the plan?

i) In this respect Treas. Reg. §1.401(a)-13(b)(2) provides that the plan shall not preclude enforcement of federal tax levies under §6331 (which covers any tax) or collection on judgments from unpaid tax assessments, and §1.401(a)-13(c)(2) provides that "[a]ny arrangement for the withholding of Federal, State or local tax plan benefits" is not regarded as an "assignment or alienation." See Hyde v. United States, 93-2 U.S. Tax Cas. (CCH) ¶50,605 (D. Az. 1993) (enforcement of §6331 levy against plan benefit of taxpayer's surviving spouse; as a community debt, the survivor's entire benefit was deemed subject to the government's levy).

ii) Curiously, however, §6324(a)(2), the lien for estate and gift taxes, by *its* terms, excepts from *its* reach the trustee of a §401(a) employees' trust.

(5) As noted above, there is some talk about adding to the Code a clone of §2206, 2207, 2207A, or 2207B to apply with respect to §2039; among the difficult issues to be addressed in drafting such a law and the will drafting in response to it (if adopted) are:

(a) Apportionment of not only the underlying estate tax but also any income tax on plan distributions deemed to be made pursuant to the right of reimbursement.

(b) Do normal annuity apportionment rules apply, and otherwise how should taxes be apportioned among various interests (does equitable apportionment apply, the value of certain credits, and so forth).

(c) May the decedent waive (or alter) this right of reimbursement or would waiver (or alteration) constitute a prohibited contribution to the plan in light of *Boyd* (discussed at page 22 in the context of §2206)?

(d) May the plan administrator rely without verification on the personal representative's certification of the amount of reimbursement due?

(6) Without question, decedents today need to be mindful of tax payment when selecting death benefit payout options, to insure liquidity will exist if needed to pay taxes due, considering each of the marital deduction, the guaranteed spousal annuity rules of §401(a)(11), the income tax consequences of all this, and any chronologically or otherwise exempt amounts.

18. Apportionment of §§2032A and 2057 Recapture Tax. If an estate qualifies for §2032A special use valuation or the §2057 family-owned business interest deduction (prior to its repeal after 2003), state law ought to (but virtually always does not) provide two specific rules:

a. The benefit of the reduction in value, and the corresponding reduction in tax, should inure to the benefit of the recipient of the qualifying property. Cf. In re Estate of Martin, 515 N.E.2d 1312 (Ill. App. Ct. 1987) (apportioning against estate beneficiaries who refused to consent to special use valuation the increase in tax attributable to their refusal effectively apportioned to those who did consent the savings attributable to their election).

b. This apportionment is appropriate because the tax should be apportioned against the qualified property if any disqualifying sale or act causes recapture of the tax benefit. By §§2032A(c)(5) and 2057(i)(3)(F) the qualified heir is personally responsible for the additional tax on recapture, but may post a bond to be relieved of that liability and may be able to argue that decedent's tax clause otherwise overrides this burden.

c. California's apportionment provision, found in Probate Code §20114, addresses these issues but in a manner that itself may produce inequities.

   (1) According to Klug, *The Effect of Special Valuation on Estate Tax Apportionment: A Plea for Uniform Legislation*, 1 PROB. & PROP. 6 (March/April 1987), the California statute would create an inequity if the reduction in tax due to §2032A were, say, $97,500 but the qualified heir's pro rate share of the estate tax were only $76,500.

      (a) Here the entire liability apportioned to the qualified heir would be wiped out, and the excess $21,000 of tax benefit would be allocated to other estate beneficiaries (to avoid wasting it).

      (b) If, however, a subsequent recapture event occurred, the qualified heir would be required to pay the full $97,500 of tax attributable thereto. Thus, the other takers would have shared in the benefit but would bear none of the recapture risk.

   (2) Klug notes that the full $97,500 of benefit might be allocated to the recipient of the qualified property if there were significant tax liability apportioned to that beneficiary (not all attributable to the qualified property) against which the benefit could be allocated, but this may not be the case.

   (3) Although the full benefit could be allocated to all takers pro rata, this would be even more unfair (unless all takers were made responsible for the recapture tax, which would create administrative problem and reduce the incentive on the qualified heir to avoid a recapture event).

   (4) Klug recommends that, in administering the estate, only a partial §2032A special use valuation election be made, to reduce the tax by only the amount of benefit that the qualified heir could enjoy, to avoid improper dispersion of the benefit.

   (5) That alternative does not seem as adaptable to the §2057 context. But in any case a side agreement might be executed whereby the other takers would agree to indemnify the recipient of the qualified property to the extent of the $21,000 excess tax liability.

d. Also a problem is the temporal interest rules. If the qualified property were placed into a trust and the life tenant were the party causing recapture, the corpus of the trust nevertheless would incur the tax under traditional temporal interest apportionment, constituting another form of inequity. But see Estate of Libeu, 253 Cal. Rptr. 456 (Ct. App. 1988) (income and remainder beneficiaries required to pay tax).

e. With respect to all of this, drafters working with §§2032A and 2057 must consider fashioning a result that is equitable and that reflects the decedent's intent, all in light of §§2032A(c)(5) and 2057(i)(3)(F) and any relevant state law. For example, the document might provide that any recapture tax will be imposed entirely on the income beneficiary if recapture is caused by a cessation of qualified use, but that the tax will be imposed in a manner that properly amortizes it against the income and remainder interests if the land or business interest is sold.

19. Apportionment of §529(c)(4)(C) Recapture. A similar issue can arise with respect to a death that occurs during the first five years following a contribution to a §529 education savings plan that took advantage of accelerated annual exclusions that is subject to recapture if the donor dies before those exclusions are "earned out." This is a phantom asset in the estate, generating an estate tax liability, that the document also should apportion. There is no body of law or general expectations that would inform an outsider asking the question whether the object of those gifts (the §529 account?) should bear that tax. This issue is similar to whether any §2035(b) gross up rule tax that is attributable to gifts made within three years of death should be apportioned to the donee or paid by the estate in general. Whatever is the decedent's intent ought to be specified because these are not items about which a body of expectations or general legal principle would inform a court's decision in the absence of guidance.

20. Apportionment of Income Tax Burdens. Estate planners don't always consider or draft for the numerous issues that surround payment of wealth transfer taxes, but they even more frequently overlook the income tax problems that arise in estate administration. Particularly with respect to changes made in 1986 to Subchapter J and related areas, tax payment provisions today probably should address several income tax issues.

a. Inequitable Sharing of DNI. Although the separate share rule of §663(c) is applicable to estates with substantially independent and separately administered shares for individual beneficiaries, distributions of otherwise equal portions of an estate can result in a sharing of estate DNI that is not what the decedent intended or the beneficiaries regard as equitable.

(1) The end result of such distributions can be a need to make an equitable adjustment, if the document does not waive the need therefor. See In re Estate of Holloway, 323 N.Y.S.2d 534 (Sur. Ct. 1971), modified, 327 N.Y.S. 2d 865(Sur. Ct. 1972), And see Blattmachr, *The Tax Effects of Equitable Adjustments: An Internal Revenue Code Odyssey*, 18 U. MIAMI INST. EST. PLAN. ¶1400 (1984); Moore, *Conflicting Interests in Post-Mortem Planning*, 9 U. MIAMI INST. EST. PLAN. ¶1900 (1975).

(2) To avoid the problem entirely, the document may dictate that distributions be made in such a manner that no inequitable allocation of estate income will result.

(a) For example, in Harkness v. United States, 469 F.2d 310 (Cl. Ct. 1972), the estate plan called for an equal split of the decedent's estate, with estate taxes and expenses being payable out of the estate prior to division but being charged entirely to one of the two halves.

(b) To maintain the equality dictated by this division, every time the personal representative paid any tax or expense, a distribution was made to the other taker in the same amount. Because the case arose before the separate share rule applied to estates the equalizing distribution carried out DNI but the payments did not, causing income to be taxed disproportionately to the share that did not incur the taxes and expenses. An equalizing adjustment was required so as to tax DNI in the same equal proportions as the estate was to be divided.

(c) Under the separate share rule the result would be the same as if the personal representative had been authorized to make equal distributions to the two shares, then the one share had used its distribution to pay the taxes and expenses, with each share receiving equal amounts of DNI.

(d) If the decedent's intent had been that DNI be shared in the same proportions as the shares resulting after payment of taxes and expenses, however, the result reached in *Harkness* prior to the adjustment would have been proper, and the separate share rule would need to be considered in how division and payment were structured.

(e) Although the document could have dictated this result, the drafter did not appreciate or anticipate the problem. Some planners will not embrace a solution that calls for payment before division because payment after division may mean that less liquidity exists in the share from which payment is to be made and, for other reasons, this detriment otherwise cannot be avoided.

(f) Because it is not possible to predict the best result of the client's intent in all cases, issues such as these simply must be evaluated in the planning process and the document drafted accordingly.

b. Tax on Appreciation at Death. If Congress were to adopt the proposed appreciation estate tax, exacting an income tax on built in gains at a decedent's death, estate planners would need to consider the payment of this additional tax liability.

(1) Estate of Ballard v. Commissioner, 85 T.C. 300 (1985), and Rev. Rul. 82-82, 1982-1 C.B. 127, and Technical Advice Memorandum 8203135 provide that the Canadian tax on appreciation at death is not an estate tax for purposes of the §2014 foreign death credit (however, each authority permitted a §2053(a)(3) deduction for the tax, as a claim against the estate, and paragraph 7 of Article XXIXB of the U.S.–Canada Convention, signed in 1995, specifically overrides both authorities and treats the Canadian capital gain at death tax as creditable under §2014).

(2) If the tax on appreciation is not an "estate" tax, the typical tax clause may not speak to the source of its payment.

(3) In addition, allocation of the benefit of any deduction for this tax under §2053 ought to be considered, particularly if the tax on appreciation might be imposed on one beneficiary while the benefit of the deduction inures to another.

(4) In addition, if Congress fails to provide some form of marital deduction or election to defer the tax until the death of a surviving spouse (or if such an election were not made), the source of payment of the tax should be considered so as to prevent the tax obligation from bring an unexpected or inappropriate §2056(b)(4) reduction of the marital deduction otherwise available to the estate.

(5) Finally, if Congress does impose such a tax, drafters will need to establish whether the tax has an apportionment regime (for example, do beneficiaries incur the tax generated by assets received by each beneficiary) and whether that tax liability may be reallocated without additional income tax cost.

c. Estimated Tax Burden. As between fiduciary accounting income and principal, presumably the portion of a trust or estate that produces an income tax liability that is subject to estimated tax payment should be charged with the payment of that tax. And it ought to be the case that a trust will not lose simple trust status if the trust uses fiduciary accounting income to pay estimated taxes incurred by income of the trust.

(1) Wait: how can the income account of a simple trust incur an income tax liability? The unfortunate answer relates to the loss of deductions under §67(e).

(2) Consider an example in which an estate's fiduciary accounting income is $500,000 and deductions subject to §67(e) are $130,000. If the expenses were a proper charge against fiduciary accounting income, the amount available for distribution would be $370,000 and the corresponding distribution deduction would be $370,000.

  (a) The §67(e) threshold amount is 2% of the remaining $130,000 of income, meaning that $2600 of deductions would be lost, leaving deductions of 127,400 and taxable income of $2,000 after reflecting the $600 deduction under §642(b).

  (b) With a tax at, say, 36% (applicable, perhaps, because of other income properly allocable to corpus), the estate would owe $720 of tax attributable to fiduciary accounting income and an estimated tax return would be necessary unless one of the estimated tax exceptions applies. A similar scenario could apply to a trust, including a simple trust.

(3) Notice that, in this example, if estate income were used to pay the estimated tax liability attributable to the income account, then less than $370,000 of income would be available for distribution, which would reduce the distribution deduction and increase the amount subject to the 2% threshold, increase the amount of taxable income attributable to the income account, and thereby increase the taxes incurred by the estate and properly allocated to the income account. Obviously the allocation of this income tax burden will be of some significance; it should not be allocated to corpus if the estate ultimately passes to beneficiaries other than those receiving current income.

(4) The problem posed here could be avoided if the deductible items were paid from corpus, so that a full $500,000 of income were available for distribution.

  (a) This would "give" the benefit of those deductions to the beneficiaries of estate corpus if distributable net income were adequate to cover the entire income distribution, in which case the income beneficiary would pay for that higher distributable net income carryout but would have a reduced DNI due to a smaller §67(e) loss of deductions.

(b) Unless the document provided for such a result, however, the normal principal and income act rules probably would dictate the results illustrated in the example (the uncertainty implicit in this statement being attributable to the fact that the estimated tax rules were first imposed on trusts and estates in 1987 and, presumably, no one previously addressed these questions).

(c) Moreover, payment of these items from corpus would hurt the form of planning involved under *Hubert*, discussed beginning at page 49.

d. Without belaboring the point, a similar computation and similar results could occur under the alternative minimum tax, attributable to items paid from fiduciary accounting income for which no alternative minimum tax deduction is available. An alternative minimum tax could be generated and, if paid using income (under normal fiduciary accounting principles), additional income taxes similarly could be incurred due to a similar loss of distribution deduction due to the use of income to pay the alternative minimum tax liability. See Hall, *The Application of the Alternative Minimum Tax to Estates and Trusts,* 22 U. MIAMI INST. EST. PLAN ¶900 (1988).

e. Finally, consider that, unlike estate taxes (which normally will be paid, and a closing letter obtained, before final distribution of an estate), the income tax liabilities and potential payment responsibilities considered here could arise several years after an estate has been closed and distributed. In this respect, fiduciaries need to pay attention to filing the proper §6903 notice of the termination of fiduciary responsibility so that, if an income tax assessment is brought, it is asserted against the proper distributees rather than the fiduciary.

E. Conflict of Laws and Enforcement Jurisdiction. Perhaps the most perplexing and least definite issues under the entire apportionment umbrella are whose law should govern apportionment questions in multiple state estates and how is an apportionment rule in one state to be enforced against property or beneficiaries in another state, especially if the law of that other state is at variance with the law of the state calling for apportionment.

1. As most litigators well know, the conflict of laws issue often is the most difficult and least predictable aspect of any controversy, and this certainly is true with respect to apportionment.

a. Based on how it sees the equities of the controversy, an apportionment question may be one that a court will want to decide a certain way on the merits, so the court may undertake to resolve the conflict of laws issue in a manner that allows the court to select the substantive law needed to render the decision it prefers.

b. In the conflict of laws arena, looking for a state whose law supports the result a court may prefer frequently involves a choice of law decision that is not entirely copacetic under accepted conflict of laws principles.

c. It probably is fair also to note that courts are prone to adopt their own state's law if possible, meaning that forum shopping to bring a case in a state whose law is favorable is a wily litigation tactic.

2. No reader should undertake to resolve the conflict of laws issue in a given situation by relying on the following overly generalized synopsis, without also consulting two extremely helpful summaries of the conflict of laws rules in this area, being Scoles, *Apportionment of Federal Estate Taxes and Conflict of Laws*, 55 COLUM. L. REV. 261 (1955), along with its sequel in Scoles, *Estate Tax Apportionment in the Multi-State Estate*, 5 U. MIAMI INST. EST. PLAN.¶700 (1971). See also Annot., *What Law Governs Apportionment of Estate Taxes Among Persons Interested in Estate*, 16 A.L.R.2d 1282 (1951).

3. Policy Principles. As a policy matter, it probably is unassailable that the law should favor four essential conflict of laws objectives in this arena, being:

   a. uniformity,

   b. predictability,

   c. equal treatment of all parts of an estate, regardless of their physical or legal location for conflict of law purposes, with application of the same rules with respect to testate and intestate assets, and

   d. equal treatment of various legal issues, applying the same conflict of laws rules for apportionment as, for example, for testing the validity of a will.

4. Rules That May Apply. As an example of how confused this area may become, however, consider the following rules, all of which potentially being applicable in a particular situation:

   a. With respect to intestate property, the law of the state of the asset's situs may be applicable, meaning the law of the decedent's domicile with respect to moveables and the law of the actual situs of the asset with respect to immoveables (land).

b. Regarding testate property, classification of the issue for conflict of laws purposes will affect the choice of law rules applied; for example:

(1) If the apportionment question is regarded as either a succession or a validity question, in all likelihood the law of the decedent's domicile will govern the choice of law.

(2) If, however, apportionment is regarded merely as an administrative question, the law of the situs of the primary estate administration may be applicable.

c. If inter vivos nonprobate transfers are involved, either the law of the donor's domicile at the time of the transfer or the law of the situs of the transferred property at the time the conflicts issue is resolved may apply for choice of law purposes (and these could differ).

d. Regarding apportionment and the use of trusts, the law of the situs of the trust for administration may govern for choice of law purposes.

e. Finally, if appointive property is involved, the traditional conflict of laws rule applies the law of the state of the domicile of the person who created the power (its donor) on the fiction that appointment relates back to the donor's estate plan, with the donee (the holder of the power) merely acting as the donor's "agent" in exercising the power or otherwise with respect to the appointive assets.

(1) The conflict of laws rule that the law of the donor's domicile, rather than that of the powerholder's domicile, shall govern is one of the most troublesome and least expected conflict rules applicable in the estate planning arena.

(2) Professor Scoles suggests that Code §2207 was enacted in large part to minimize the difficult and unexpected effect of this conflict of laws rule. See Scoles, *Apportionment of Federal Estate Taxes and Conflict of Laws*, 55 COLUM. L. REV. 261, 285 (1955).

5. Proper Resolution. Professor Scoles also argues that the proper resolution of a conflict of laws issue in the apportionment setting should follow a two step analysis.

a. First, the law of the situs of property should apply to determine whose law will govern the choice of law question.

(1) Thus, if a trust is involved, the choice of law rules of the state of trust administration should govern with respect to the choice of law issue.

(2) With respect to transfers at death, situs law also should govern the choice of law, whether the assets are probate or nonprobate and regardless of whether administration is domiciliary or ancillary.

6. To illustrate that this suggestion is not necessarily what the courts of a given jurisdiction will adopt, the reader need only compare Doetsch v. Doetsch, 312 F.2d 323 (7th Cir. 1963) (law of the decedent's domicile governed apportionment involving inter vivos trust),with Isaacson v. Boston Safe Deposit & Trust Co. 91 N.E.2d 334, 16 A.L.R.2d 1277 (Mass. 1950) (law of situs of trust governed apportionment).

7. <u>Insuring Consistent Results</u>. As a consequence, probably the only way to insure consistent apportionment results is to either:

   a. designate the applicable law with respect to all assets, which cannot be done in many cases because there is no way to designate the governing law with respect to some assets, or

   b. provide for tax payment and apportionment that does not rely in any manner on state law.

8. <u>Jurisdiction</u>. The jurisdiction issue is whether a personal representative with a duty to apportion taxes can obtain jurisdiction over takers of nonprobate property located in other jurisdictions.

   a. Section 8 of both the Uniform and the Revised Uniform Acts provides that an out-of-state personal representative may bring an action in the enacting state to obtain reimbursement from a nonprobate beneficiary located in the enacting state.

   b. Each version of the Uniform Act requires that the state of the decedent's domicile be a "reciprocity" state to qualify for this privilege; reciprocity is not always clear in states that are silent on the issue of jurisdiction over nonprobate beneficiaries.

   c. Absent a statutory right to bring an action, whether a personal representative will obtain jurisdiction over a recalcitrant nonprobate beneficiary is guesswork.

   d. The Uniform Acts (and other state laws as well) grant a right of set off against the probate share of an individual, allowing the personal representative to withhold testate assets pending full contribution with respect to nonprobate assets that the individual also takes.

(1) In many cases this is sufficient to cover the apportioned liability, because the taker of nonprobate property also frequently receives sufficient probate property to cover the total allocated tax liability.

(2) This is, however, at best a partial solution if the nonprobate taker receives a small share of probate property and bears a heavy allocation attributable to receipt of substantial amounts of nonprobate property.

e. Professor Scoles suggests that Code §2205 grants a federal right of action to beneficiaries of an estate who suffer from an inability to apportion taxes against takers of *probate* property located in another state; this does not, however, assist in obtaining judgment against out-of-state takers of *nonprobate* property who fail to comply with an outside apportionment dictate of the law of decedent's domicile. See Scoles, *Estate Tax Apportionment in the Multi-State Estate*, 5 U. MIAMI INST. EST. PLAN. ¶718.2 (1971).

III. <u>Planning Aspects of the Apportionment Rules</u>.

A. If experience is any guide, even accomplished drafters and estate planners devote little thought to questions regarding tax clauses once the task of creating formbook trust and will provisions is complete, and issues such as those discussed below frequently never are considered in the context of individual estate plans. Today such a failure to consider these issues on a routine basis probably is inappropriate, even in most "normal" situations.

B. <u>Planning and Drafting Issues</u>. The following segment addresses three basic aspects of drafting tax clauses in light of the apportionment rules above.

1. First, a number of glitches and disadvantages can be identified for avoidance in planning and drafting.

2. Second, several uncertainties that may affect administration are isolated for consideration.

3. Third, affirmative planning choices and their merits are explored.

C. <u>Glitches to avoid</u>.

1. Because state law may shift the tax payment liability to nonprobate takers under applicable apportionment rules, the interests of those takers must be considered

during administration of the estate to avoid unintentionally affecting their rights without their knowledge or consent.

a. If a state court might decide that they are entitled to representation regarding administrative decisions that affect them, failure to notice or join these beneficiaries may invalidate certain orders obtained or actions taken during administration of an estate.

b. One easy mechanism to avoid this concern (and the general lack of state law to dictate the requisite form of joinder or notice) is simply to direct that all taxes be paid out of the probate estate.

c. If negation of apportionment under state law is not appropriate or desirable,

(1) state law might permit the decedent to indemnify the fiduciary from liability to nonprobate takers and direct that all decisions of the fiduciary in the ordinary course of probate administration shall be final, without notice or joinder.

(2) On the same theory that a decedent in a nonapportionment state may allocate taxes to nonprobate assets (because a sufficient nexus exists to require inclusion of the asset in the first instance), it ought to be permissible to "disadvantage" or restrict the rights of nonprobate beneficiaries in this lesser fashion.

2. <u>The federal reimbursement provisions (§§2206, 2207, 2207A, and 2207B) are not apportionment provisions</u>. Under these sections the estate initially pays its tax liability and then is entitled to reimbursement.

a. As a consequence, liquidity may not be where it needs to be and collection problems may arise or be exacerbated by the existence of multiple beneficiaries, all subject to these rights of reimbursement. In this respect, directing apportionment in the first instance rather than preserving these reimbursement rights many be more expeditious.

b. In addition, §2207A creates a significant and easily overlooked gift tax liability if taxes subject to reimbursement are not collected by or on behalf of the beneficiaries entitled to assert the right of reimbursement.

(1) During life, gift taxes attributable to relinquishment of any part of a life estate in qualified terminable interest property are subject to reimbursement and failure to collect disregarded as an added gift by the surviving spouse who relinquished the income interest.

(2) Similarly, at death, failure to collect the §2207A reimbursement of taxes caused by §2044 inclusion may result in a gift (even if collection would have proved impossible) if beneficiaries of the §2044 property differ from recipients of the surviving spouse's estate. See Treas. Reg. §20.2207A-1(a). This problem presumably is avoided if the surviving spouse's estate pours over in the QTIP trust (or passes as that trust does) so that the same beneficiaries are both benefited and hurt by the failure to assert the reimbursement right.

(3) One difference between the inter vivos and testamentary consequences of §2207A is that the right of reimbursement at death may be waived, with a concomitant relief from this gift tax consequence. See Treas. Reg. §20.2207A-1(a).

c. If a gift occurs due to a failure to either waive or assert a right of reimbursement, that gift will be the result of the personal representative's failure to act, while the gift (and therefore the tax to be paid thereon) is regarded as made by the beneficiaries affected by this inaction.

(1) It seems entirely possible that those beneficiaries will be unaware of the fiduciary having caused this gift, meaning that a return may not be filed and substantial interest and penalties may be imposed.

(2) Especially if a non-professional personal representative is involved, (s)he should be made aware of the gift tax exposure, perhaps by including a warning to the personal representative to this effect in both the QTIP trust and in the surviving spouse's estate plan.

d. In addition, §2207A may produce an unexpected inequity attributable to QTIP property being taxed at the highest estate tax rate applicable to the surviving spouse's estate, if that property passes to the settlor's remainder beneficiaries and the surviving spouse's property passes to the survivor's beneficiaries and the parties expected that the aggregate tax burden would be shared proportionately.

e. Unfortunately, although it would eliminate all these problems, waiver of the right of reimbursement may leave taxes of such magnitude (caused by inclusion of the QTIP trust in the surviving spouse's estate) that probate assets are insufficient to pay those taxes; in such a case waiver *alone* is not a viable alternative. Nor would waiver be necessary if no gift would result (due to identity of the beneficiaries).

f. In most cases, the better approach is to waive federal reimbursement rights but preserve all state law apportionment rights, except with respect to specifically designated assets or classes of assets.

3. <u>Temporal Interests</u>. A third negative result of the apportionment rules in most states relates to the manner in which taxes attributed to annuities, life estates, and terms certain are allocated.

   a. Because paid out of principal in most cases, it is possible for the taxes on a lead beneficiary's interest to diminish the share of the remainder beneficiaries. Thus, for example, if §2207A applied to a QTIP trust that continued after the surviving spouse's death for the life of a secondary income beneficiary, remainder to a third party, the income beneficiaries presumably would be protect — except to the extent a reduction in corpus reduces income therefrom and essentially amortizes the tax burden.

   b. If the lead interest is nondeductible but the remainder qualifies for either the marital or charitable deduction, the consequence of this apportionment rule is to reduce the size of the deduction, increasing taxes as a direct consequence and thereby increasing the diminution of the deductible amount, again increasing the taxes incurred, ad infinitum.

      (1) By way of example, if a trust required income to be paid to parent for life, remainder to surviving spouse, the remainder would qualify for the marital deduction.

      (2) Similarly, qualified charitable remainder trusts present the same problem.

   c. In such cases in states that embrace both equitable apportionment and the apportionment rule allocating taxes attributable to a lead interest to the remainder, the result is a conflict, usually resolved in favor of forcing corpus to pay, with unfavorable results for deduction purposes.

   d. Resolution of this problem would require taxes on the lead interest to be directly apportioned to the lead interest (rather than indirectly doing so by amortization), itself creating a problem of how those taxes are to be charged.

      (1) For example, if the taxes are substantial, will the lead interest beneficiary be able to pay the cost of an immediate apportionment?

      (2) It is no solution to charge the tax to corpus and argue that this necessarily reduces the income interest over time, because the charge to corpus reduces the deduction.

      (3) It might be possible to "borrow" from corpus the amount of taxes attributable to the lead interest, with repayment out of income earned over time or reduction of an annuity; however, in a qualified charitable remainder trust, such a loan may constitute a prohibited form of self-

dealing and reduction of the annuity would affect computation of the deduction.

e. Alternatively, waiver of apportionment entirely may avoid the problem if another fund exists for tax payment purposes and imposition of the tax liability also will not reduce available deductions.

f. Section 2207B(e) provides that no taxes will be apportioned under §2207B to a qualified charitable remainder trust and appears to be directed at preventing reduction of the charitable deduction by virtue of the split interest apportionment rules.

4. Employee Benefits. Similar to the preceding discussion, taxes attributable employee benefits includible in the estate under §2039 must be considered.

a. Thus, if the benefits are payable in annuity form, the temporal interest issue discussed above exists, with the same set of available solutions.

b. If the recipient is the decedent's surviving spouse and a marital deduction is sought, equitable apportionment must be considered.

c. In each case in which apportionment is considered with respect to employee benefits, the planner must carefully consider beneficiary designations and the terms of the plan.

(1) If the settlement of the plan is not in a lump sum, can the beneficiary afford to pay taxes imposed by apportionment?

(2) If not, does the plan permit apportionment against the plan itself?

(3) If the answer to both these questions is no, then the planner must consider some other beneficiary designation, or some other source for payment of the tax. All other things being equal, it probably is wiser to impose tax on the beneficiary, not on the plan, and then attempt to provide the beneficiary with the funds to pay that tax, thereby avoiding plan restrictions, §401(a)(11) concerns, and so forth.

(4) The planner also must pay careful attention to whether the spousal annuity rules will prevent the type of payout otherwise desired.

(5) In a community property jurisdiction, it also is necessary to consider inclusion in the estate of a nonparticipant spouse of his or her community property interest and whether it will qualify for the marital deduction or generate tax that probably cannot be allocated to the plan

and may not be apportionable elsewhere because the participant is not yet in pay status.

(6) Finally, the income tax consequences of the payout option selected, and of the tax apportionment selected, also should be considered.

5. As a practical matter, estate planners must consider whether the breadth of nonprobate assets is such that apportionment would be difficult (if not impossible) to administer and, if so, whether the tax clause should waive apportionment or reimbursement (at least with respect to certain assets or classes of property). With all the various forms of nonprobate property and taxes that may be involved, however, it seems unlikely that blanket waiver of all apportionment or rights of reimbursement will be appropriate or feasible. This reality informs several provisions in the sample tax clause found beginning at page 127, particularly paragraphs 1.2.6.4 and 1.4.4.

6. Finally, as noted above, in some states it is uncertain how various computations and allocations are to be made and in what order, in which case the estate plan should establish the mechanism and dictate apportionment consistent therewith.

D. Administration Uncertainties. During (and in anticipation of) estate administration, a number of uncertainties or problems may affect the personal representative and ought to be considered at the time the estate plan is prepared.

1. Effect of Audits. One is the effect that an audit will have on the determination of estate and inheritance taxes and the apportionment and collection thereof.

   a. If values change, resulting in either a change in taxes payable or simply a readjustment in the relative size of various shares, any previously determined allocation of taxes under an apportionment routine will be affected. This will be particularly true in a state that imposes different wealth transfer tax rates, based on degrees of consanguinity, if property subject to the audit changes passed to beneficiaries in different degrees and the rate differential is apportioned under state law.

   b. The issue is whether it is prudent to distribute the bulk of an estate prior to final determination and collection of taxes. This issue is addressed in the sample tax clause found beginning at page 127, paragraph 1.4.3.

   c. The planner should consider whether needs of the beneficiaries are such that a mechanism must be established for early distributions with allocation of taxes secured by a lien, bond, repayment agreement, or other method, or whether apportionment should be waived entirely (or waived with respect to changes resulting from audit).

2. Collection. Problems of collection and asserting jurisdiction over nonprobate takers should be considered before the death of a client, with measures taken to alleviate potential problems by waiving apportionment or assuring an ancillary administration in the beneficiary's domiciliary state to obtain jurisdiction. This issue is addressed in the sample tax clause found beginning at page 127, paragraph 1.4.4.

3. Conflict of Laws. Conflict of laws issues should be anticipated, especially if a change of the client's domicile is likely or if a conflict of laws battle is anticipated because of the nature and location of nonprobate assets.

   a. This probably is the easiest potential problem to address, with the estate plan adopting either or both of two defensive procedures.

   b. First, the estate plan may dictate the method of apportionment (if any) desired, thereby alleviating the vagaries of state law and uncertain application of any state's rules.

   c. Second, the estate plan may dictate the law that should apply, making certain that there is a substantial relation of the client's estate or estate plan to the jurisdiction whose law is selected (and that the policies of the governing law state do not violate any strong conflicting policy of any state that might be deemed to have the most significant relationship to the client's estate).

E. Planning Choices. Based on all the foregoing, the following segment attempts to indicate all the affirmative planning options or decisions required with respect to apportionment.

1. Marital Deduction. Effective apportionment of taxes may restrict the entitlement of a surviving spouse.

   a. For example, if the client selects a qualified terminable interest property trust format for marital deduction purposes because the client wants to tie the hands of the surviving spouse,

      (1) the likelihood of the spouse electing against the estate to take a statutory forced share outright is greater than if the spouse were given more control, and

      (2) the client's choice of such a "handcuff" trust for the spouse may indicate that minimization of a statutory forced heir share would be appropriate.

   b. This outline is not the proper forum to discuss available methods to effectively reduce the size of a client's estate for forced share purposes, but apportionment of taxes is a planning tool that may assist in accomplishing this objective.

(1) In states that recognize equitable apportionment, the share of the spouse will be computed before determination of taxes; the forced heir share will be larger because taxes are not charged against it.

(2) Although the concept of equitable election in most states will prevent a tax clause from working to the *benefit* of a surviving spouse who elects against the estate, it may be possible in a tax clause to specify that equitable apportionment will *not* apply if the spouse elects against the estate. Such a provision might not be valid. See, e.g., Rockler v. Sevareid, 691 A.2d 97 (D.C. Ct. App. 1997), holding that the elective share in the District of Columbia was computed before tax due to equitable apportionment and that the decedent's will, which imposed the tax liability on the residue without apportionment, was not effective to alter this because the spouse's election had the effect of rejecting all provision in the will that affected the spouse's entitlement. Nevertheless, it probably cannot hurt to attempt to override a state law equitable apportionment result by specifying in the client's tax clause that taxes shall be apportioned without regard to the marital deduction if the spouse elects against the decedent's estate plan.

c. Charitable Remainder QTIP Trust. The Journal of Taxation carried a number of letters in its "Shop Talk" section that indicated some doubt about the effect of tax payment on the combined marital and charitable deduction under a plan leaving a life estate to a surviving spouse in a §2056(b)(7) qualified terminable interest trust with remainder to charity. See 59 J TAX. 287 (1983) and 60 J. TAX. 200 (1984).

(1) In essence, the question was whether imposition of tax at the death of the surviving spouse under §2044 would cause diminution of the remainder that otherwise would qualify for the charitable deduction.

(2) The argument that it might is circular, based on a logic that any tax imposed would reduce the remainder which would reduce the deduction which would result in tax in the first instance that would then befall the remainder, ad infinitum.

(3) In reality, because §2044 calls for inclusion at the surviving spouse's death and §2055 will grant the surviving spouse a full charitable deduction (as if the property had been owned outright by the surviving spouse and transferred directly to the charity), there should be no taxes, the net effect being a wash.

(4) It might be appropriate to preclude any argument by the IRS to the contrary by simply negating the effect of §2077A, avoiding the suggestion that taxes under §2044 are automatically payable from the remainder under that section's apportionment rule; such negation must, however, come in the will of the surviving spouse who is otherwise entitled to its benefit and, in an outside apportionment state, the surviving spouse also ought to negate that dictate to impose tax on the spouse's probate estate.

d. Partial QTIP Election. If only a partial qualified terminable interest election is made, perhaps taxes generated by that decision should be paid out of the nonelected portion of the marital deduction trust. See Private Letter Ruling 8301050 and Comm. Rep., Death Tax Clauses in Wills and Trusts: Discussion and Sample Clauses, 19 REAL PROP., PROB. & TRUST J. 495, 509-510 (1984). This issue is addressed in the sample tax clause found beginning at page 127, paragraph 1.2.3.5.

(1) By proper accounting, this decision should not affect the amount includible at the death of the surviving spouse, at least if equitable apportionment applies, because taxes would not be paid from the qualified portion in any event.

(2) Forcing payment of taxes from the nonelected portion of the QTIP trust has the advantage of preventing an alteration of the decedent's estate planning equities if the QTIP and decedent's bypass trusts benefit different remainder beneficiaries. Otherwise, payment from the bypass trust of taxes incurred by virtue of a partial QTIP election would shift taxes from the death of the surviving spouse (under §2044) imposed on the QTIP trust (under §2077A) to the death of the decedent, imposed on the bypass (assuming that is how the decedent's tax clause otherwise apportions all taxes to avoid reduction of the marital deduction).

(3) To work properly and without conflict with the Service, the qualified and nonqualified portions of the marital trust physically should be segregated following election, making it easier to identify each and to justify the apportionment of taxes to the nonqualified portion without jeopardizing the marital deduction for the qualified portion.

(4) Further, Private Letter Ruling 8517036 illustrates that it is important to draft the provisions of the nonqualified portion in such a way that making taxes payable from that portion will not affect deductibility of the elected portion.

(a) In that Ruling, the effort was to qualify a bypass trust that contained a tax payment provision. Had the government allowed the 100%

election sought by the estate, there would have been no taxes and the provision authorizing payment of taxes from that bypass trust would have had no effect.

(b) As it was, however, the government opined that §2056(b)(4) required reduction of the otherwise allowable marital deduction by the full amount of taxes that could have been paid from that trust — in this case, as if no marital had been elected.

(c) In the context presented here, the thought is that taxes be made payable from the nonqualified portion only if it is a separate trust to which the nonelected property is added and that it be drafted in such a manner that it is clear that no part of the otherwise qualifying marital property could be diverted to the payment of taxes.

e. Disclaimer. A similar concern should apply if the surviving spouse disclaims part of the marital bequest, causing taxes to be incurred. These taxes also should be payable from the disclaimed property and, if the disclaimer would send the property to grandchildren or more remote beneficiaries, incurring a generation-skipping direct skip tax, that tax also probably ought to be imposed on the disclaimed property. This issue is addressed in the sample tax clause found beginning at page 127, paragraph 1.2.3.5.

f. Order of Events. Finally, some thought ought to be given to the proper sequence for payment of taxes in relation to division of an estate into shares under a fractional marital deduction entitlement or in conjunction with a partial qualified terminable interest election.

(1) For example, assume that the decedent's estate plan or a partial election called for a marital deduction of a certain fraction of the estate (not that amount needed to reduce taxes to zero) and, because of other assets passing to the spouse, the amount specified totals $1,000,000 to be set aside (by fractional distribution or qualified election) for the benefit of the surviving spouse.

(2) Accepting that equitable apportionment dictates that no taxes be paid from the marital share, a question still remains regarding division and payment of taxes.

(a) In this case, assume that the estate was $4,000,000 at death and that taxes imposed on the nonmarital estate (including nonprobate properties) total $1,000,000, leaving $3,000,000 after payment of the tax (of which $1,000,000 is to qualify for the marital deduction).

(b) Before the time for final distribution of the estate (but after payment of the taxes), assume that the remaining $3,000,000 increases fourfold in value to $12,000,000 (which is not entirely unlikely if the proper assets exist, and in any event the illustration is easier with these assumptions).

(c) At the time for final distribution of the spousal share or segregation of the elected and nonelected QTIP portions, is the proper fraction one-third of the $12,000,000 or one-fourth? (Note that, in all of this discussion, it is assumed that no other distributions are made that would require adjustment of the fraction. Although this also is not realistic in practice, again it makes the illustration easier.)

   i) The one-third argument is based on an assumption that the decedent was directing a fraction of the true or net residue, *after* payment of all taxes, with the fraction being $1,000,000/3,000,000 to generate the proper sized entitlement using date of death values.

   ii) The one-fourth argument is based on an assumption that the decedent was directing a fraction of the gross residue, *before* payment of all taxes, with equitable apportionment dictating that all the $1,000,000 of taxes be paid from the nonmarital share, making the spouse entitled to $1,000,000/4,000,000 and the remaining three-fourths bear the taxes after division.

(d) Under either argument, the government appears to have no problem with the marital entitlement being $1,000,000 (using date of death values), protecting qualification of the marital deduction.

(e) Obviously, however, the issue is worthy of consideration because, in this simple example, the difference in result between one-third or one-fourth of the $12,000,000 ultimately available is a modest $1,000,000 to the spouse. Indeed, because the same fraction would affect distribution of estate income during administration, the stakes can be even greater.

(f) If a client's intent is to freeze the spouse's estate to the extent possible, or to maximize the amount of generation-skipping exemption allocated to a bypass trust, the one-fourth of gross estate fraction is best. Most drafters probably call for the one-third division, however, either by inadvertence or because that result best protects the surviving spouse.

(3) Notice that the issue is not determination of the size of the deduction, nor is it whether equitable apportionment should apply; the simple issue is whether taxes are paid first, followed by division, or whether division occurs first, followed by payment out of the nonmarital fund.

(4) The estate plan (and, for that matter, any prenuptial agreement that dictates such a bequest) ought to be clear in defining terms such as the "residue" available for division or distribution and whether it is being referred to as that amount before or after payment of taxes.

(5) See, e.g., Barley v. Albertini, 694 So. 2d 843 (Fla. Ct. App. 1997), in which the tax payment provision preceded all other provisions in the document and directed payment from the "residuary estate," along with the proviso that "[I]n no event shall any portion of such taxes be apportioned or allocated to my spouse or any property passing to my spouse . . . which qualifies for the marital deduction." Two paragraphs below this the marital trust was described as "90% of the *remainder* of my estate . . . after the payment of . . . taxes . . . referred to above." The trial court held that taxes should be paid first and the marital trust created out of the remaining balance, meaning that 90% of the taxes effectively would be paid from the marital bequest. On appeal the court reversed and remanded because an ambiguity existed. Between the inconsistent statements in the two provisions — relating to nonapportionment to the spouse and division after payment — along with the different terms used in the two provisions, this conclusion appears to be an understatement.

(6) See also Leavenworth Nat'l Bank & Trust Co. v. United States, 1996 U.S. Dist. LEXIS 7046 (D. Kan. 1996) (direction to pay taxes from residue of estate "without the necessity of charging them against the interest of any beneficiary," followed by pour over of the residuary estate to an inter vivos trust, which distributed half to the decedent's surviving spouse, deemed to negate equitable apportionment because of the chronology and the documents in which the payment and the bequest appeared); Banker v. Northside Bank & Trust Co., 1996 Ohio App. LEXIS 930 (Ohio Ct. App. 1996) (division equally between decedent's surviving spouse and child of a former marriage, with the chronological order in which the provisions appeared in the document — pay taxes first, then divide — deemed significant in determining that the marital share should be computed net of estate taxes; state law equitable apportionment deemed overcome by a statement in the tax payment provision that the fiduciary "shall not seek to recover . . . taxes from any Beneficiary").

(7) A similar problem involving the charitable deduction is illustrated by two conflicting cases: Greene v. United States, 447 F. Supp. 885 (N.D. Ill. 1978), and In re Estate of Bell, 764 P.2d 689 (Wy. 1988), in which the court held that the Uniform Estate Tax Apportionment Act was superseded by a tax payment provision directing payment of all taxes from the residue of the decedent's estate. See also In re Estate of Robinson, 720 So. 2d 540 (Fla. Ct. App. 1998) (reformation of tax payment direction to change from payment before division into marital and nonmarital bequests to provide instead for division followed by payment from the nonmarital alone); American Cancer Society v. Estate of Massell, 373 S.E.2d 741 (Ga. 1988) (decedent bequeathed portion of undefined "said estate" to charity; court determined that, notwithstanding tax payment provision calling for division of residue after payment of taxes, decedent did not intend to reduce the residue before division and adopted a gross estate division that effectively reflected equitable apportionment and preserved charitable deduction).

(a) In *Bell* the residuary provision included two charitable bequests of a fraction of the residue; the charities argued that equitable apportionment should apply so that a gross residue division would be made and all taxes would be paid from the noncharitable portion of the residue.

(b) The court concluded that the tax payment direction overrode all portions of the Uniform Act, including equitable apportionment, and held that net estate division was mandated by the chronological aspect of the will, directing payment of taxes and then division of the balance of the residue.

(c) Consistent about *Greene* is that the court also applied a chronological interpretation, by which division and payment of taxes was deemed to occur in the order in which the respective provisions were found in the documents. That approach is not always best, nor do courts always follow it, making proper anticipation of these issues essential in the initial drafting of the document and each of its provisions.

(d) The court did not even mention the effect of this conclusion on the §2055 charitable deduction, nor did it discuss equitable apportionment as a matter of policy that might guide its decision. Similar cases are In re Estate of Robbins, 544 N.Y.S.2d 427 (Sur. Ct. 1989), In re Estate of Atkinson, 539 N.Y.S. 112 (A.D. 1989), and Technical Advice Memorandum 9616001 (debts, expenses, and taxes attributable to preresiduary bequests were payable from residue and reduced amount charity received by virtue of partial disclaimer by decedent's sibling, but equitable apportionment applied within a residuary bequest split between the charity and the sibling and assessed all taxes incurred by the residue against the sibling's share). And see Estate of McKay v. Commissioner, 68 T.C.M. (CCH) 279 (1994), in which a §2055(c) reduction of the charitable deduction squarely was involved under a similar tax payment provision in a will that was found to overcome equitable apportionment within the residuary estate.

2. <u>Use of Credits</u>. Apportionment of the benefit of credits available to the estate under §§2010 through 2015 also should be considered.

   a. The general rule is that, excepting credits attributable to charges actually borne by the recipient of a particular asset, these credits work to the overall benefit of the estate, not to the benefit of any particular beneficiary.

   b. The client may, however, prefer that the recipient of property subjected to a foreign death tax be granted the benefit of the credit therefor, notwithstanding the general rule.

   c. Failure to consider the effect of credits under general allocation rules can work unexpected consequences.

      (1) For example, lack of apportionment in an estate can work an unintended inequity with respect to the §2013 credit available to the estate of a beneficiary who dies within ten years after the client.

         (a) On death of that beneficiary, taxes paid by the client's estate on property subsequently included in the beneficiary's estate qualify as a §2013 credit against the beneficiary's estate taxes.

         (b) If the taxes paid by the client's estate (generating the credit) were not originally charged against that beneficiary, the result is the beneficiary's estate enjoying a credit generated by the payment of the client's estate taxes by other individuals.

      (2) In certain circumstances it might be appropriate to preserve apportionment so that each beneficiary is obliged to pay the tax on the property (s)he receives, thereby "paying" the price for any possible §2013 credit that ultimately many be generated.

   d. With respect to property transferred by gift by the client during life, the result of the normal sharing of credits could cut either way.

(1) If the gifted property subsequently is included in the client's estate under any of §§2035-2038, 2040, or 2042, the donee may be required by apportionment to bear a pro rata portion of estate taxes allocable to the gifted property, which may be an amount well in excess of the actual gift taxes incurred by the decedent at the time the gift was made. This would be true particularly with respect to life insurance, with its low gift tax value but much greater estate tax inclusion, and apportionment to the beneficiary is especially appropriate with respect to insurance because the proceeds provide such a ready source of liquidity and the tax could be such a large liability.

(2) If the donee is not required to bear a portion of the estate tax caused by inclusion of the gifted property, the donee enjoys the benefit of credits that otherwise are reserved to the estate as a whole.

(a) If the donee is not a beneficiary of the estate, the donee "enjoys" estate tax credits because the gifted property is included in the adjusted taxable gifts base for estate tax computation purposes but the donee is not required to contribute to the taxes caused by that inclusion. See, e.g., In re Metzler, 579 N.Y.S.2d 288 (App. Div. 1992), and In re Estate of Coven, 559 N.Y.S.2d 798 (Sur. Ct. 1990) (apportionment against taxable gifts that are not included in the decedent's gross estate is not permitted notwithstanding that the gift pushes the estate into a higher marginal bracket for estate tax computation). And see In re Estate of Detlefs, 418 N.W.2d 571 (Neb. 1988), which denied to the donees of inter vivos gifts the exclusive benefit of the credit for gift tax paid by the decedent's estate, noting that the gifts increased the tax burden of all beneficiaries of the estate and that the estate in general therefore should benefit from the gift tax payment.

(b) Indeed, the gift may have "used" the unified credit long before the client's death. For example, see In re Estate of Finke, 508 N.E.2d 158 (Ohio 1987), which involved nonprobate assets transferred within three years of the decedent's death but included in the estate for state (but not for federal) estate tax purposes.

i) Because the unified credit precluded a gift tax on the inter vivos transfers, the court held that the unified credit was a "credit directly attributable to a particular . . . gift [which] shall inure to the benefit of the . . . donee" under Ohio Rev. Code §2113.88.

ii) With that entitlement, the court held that apportionment of tax to the inter vivos donees was precluded because the credit exceeded the state tax liability on the gift. In essence, therefore, those donees enjoyed the unified credit to the exclusion of other objects of the donor's bounty.

(c) Contra, Shepter v. Johns Hopkins University, 637 A.2d 1223 (Md. Ct. App. 1994), which held that taxes otherwise payable from the residue of the decedent's estate, which passed to charity, should be apportioned against the beneficiary of an inter vivos gift that constituted an adjusted taxable gift and boosted the estate tax marginal bracket but otherwise was not includible in the decedent's gross estate for estate tax purposes (and apparently did not generate a gross-up tax problem under §2035(b) either), stating that full apportionment as adopted in states that enacted the Uniform Estate Tax Apportionment Act should include donees of gifts that are included in the estate tax computation. By ch. 55 of Acts 1995 the Maryland legislature effectively rejected the result in *Shepter*, stating that the reference in Md. Code Ann., Tax-General §7-308(a)(4) to persons to whom estate tax may be apportioned does not include the recipient of an adjusted taxable gift from the decedent that is not includable for estate tax purposes, "notwithstanding any holding or dictum to the contrary in *Shepter v. Johns Hopkins University.*"

(d) The client may wish to consider whether some form of adjustment should be dictated so that recipients of assets during life are not placed at an advantage over beneficiaries who receive shares of the estate at death; waiver of apportionment may be the only way to insure that all beneficiaries receive their shares tax free (but this form of equalizing various shares will work only if a fund will remain for payment of taxes after all equalizing bequests have been satisfied).

(e) More importantly, it should be remembered that use of the unified credit during life generates a larger benefit than use at death, meaning that the inter vivos donee is favored even if credits otherwise are shared by a waiver of apportionment provision.

i) For example, a client who wanted beneficiaries A and B each to receive $1,000,000 in value at the time of the client's death could follow either of two approaches.

(A) The client could leave each $1,000,000 at death.

(B) Alternatively, the client could presently transfer a remainder interest in property that will be worth

$1,000,000 at the client's death (and, for the sake of argument, avoiding §2036(a)(1) inclusion at death by transferring the intervening life estate to another party).

(C) For gift tax purposes, the value of the transferred remainder would be the discounted present value of $1,000,000 and the gift tax on that discounted value would be less than the estate tax on $1,000,000 at the client's death due to both the discounting and the tax exclusive nature of the gift tax.

(D) Even if each beneficiary were required to bear the proportionate taxes allocable to the interest each received, that would impose the tax on a gift of only the discounted value if made during life rather than the tax on a full $1,000,000 if made at death (or if the gifted property were included in the gross estate).

ii) If the client wanted to equalize the treatment of the beneficiaries by adjusting for use of the unified credit during life, any tax allocation to beneficiaries should reflect the value of their respective entitlements — determined at the same time, not at the time the various transfers were made — and reflect the time-use value of any monies the donee used to pay taxes on the gift prior to the client's death. This issue is addressed in the sample tax clause found beginning at page 127, paragraph 1.2.1.3.

iii) Although a net gift approach would avoid some of the inequity considered here (because the donee loses the use of the donee's money), the tax bracket at which the tax would be imposed might be lower by virtue of the gift and discounting technique, and the DuPont effect would benefit the donee. Furthermore, the net gift approach would not be available until the unified credit is exhausted. Rev. Rul. 79-398, 1979-2 C.B. 338. This issue is addressed in the sample tax clause found beginning at page 127, paragraph 1.2.3.1.

(f) A closely related planning issue was raised by gifting done by the decedents whose estates were involved in Private Letter Ruling 9339010, Armstrong v. Commissioner, 114 T.C. 94 (2000), and Brown v. United States, 2001-2 U.S. Tax Cas. ¶60,424 (C.D. Cal. 2001), who made substantial gifts and paid millions in gift tax within three years of death, triggering application of the §2035(b) gross up rule in the decedents' estates at death. Inclusion of the gift tax in the decedents' gross estate produced estate tax, sometimes exceeding the amount of the decedents' remaining probate estates available for payment of that liability. This issue is addressed in the sample tax clause found beginning at page 127, paragraph 1.2.1.2.

i) Although the taxpayer in the Ruling only asked it to compute the decedent's estate tax, the government opined that "under State law, the federal estate taxes are to be apportioned" among the donees of the gifts, citing no authority (which made it impossible to verify the government's conclusion; a computer assisted search as well as discussions with several commentators who have extensive experience in this area were unsuccessful in determining that any state has a tax apportionment rule that is on point).

ii) The Ruling did not establish the donee's responsibility to pay the tax as either a gift tax or estate tax transferee liability under §6324, although *Armstrong* establishes that it could.

(A) The tax is not a gift tax imposed by chapter 12 as required for application of §6324(b) gift tax transferee liability.

(B) But estate tax transferee liability under §6324(a)(2), which applies to any "beneficiary, who receives, or has on the date of the decedent's death, property included in the gross estate under §§2034 to 2042, inclusive, to the extent of the value, at the time of the decedent's death, of such property," is made applicable by §2035(c)(1)(C), which deems the gifted property to be includible in the gross estate for purposes of the lien provisions.

(C) Thus, although it is not accurate to consider the donees as receiving the property that produced the estate tax (because the federal government received the gift tax upon which the estate tax was incurred), the lien nevertheless exists. Curiously, however, the Ruling did not depend upon this analysis or even mention §2035(c)(1)(C). More curious yet is: If this federal law is the relevant authority, it is not clear why the Internal Revenue Service opined regarding a question of state law.

(D) One way to avoid the §2035(b) issue with a married terminal donor is to split the gift and have the surviving consenting spouse pay all the gift tax on both halves of the split gift.

iii) Of the limited sources for payment of the gross up rule estate tax, it is equitable that the donees who received the gifted assets should pay the tax generated by the property they received, as presumably they would if the decedent had died with that property includible in the gross estate and left it to the donees at death. Without that result in this situation the tax would remain unpaid, and it hardly seems proper that a decedent should be able to make gifts shortly before death that, coupled with the gift tax itself, would diminish the decedent's estate to the point that the gross up rule estate tax could not be paid and therefore would be avoided entirely.

iv) A related situation was involved in Technical Advice Memorandum 9729005, in which the government addressed the interplay of the gross up rule now found in §2035(b) and the split gift provisions of §2513 and the ability of a donor's spouse to pay all the gift tax incurred on a split gift without added gift tax consequences. The facts revealed that D had four children, three by a former spouse and one with S. D wanted to make sizeable lifetime gifts to these children but most of the couple's wealth in the community property jurisdiction in which they lived was D's separate property. So D wrote a check against D's separate property account to S, who two days later wrote a check in the same amount to fund a trust for D's four children. D elected to split S's gift for §2513 gift tax purposes and, when the gift tax on that transfer was coming due, D again wrote a check to S on D's separate property account for the full amount of the gift tax on both halves of that split gift; S wrote a single check the very next day to pay all the gift tax on both halves of the split gift. S had insufficient funds to make either the gifts or to pay the gift tax, without the checks written by D, who died within three years of these events.

(A) On these facts the government required inclusion in D's gross estate of the full gift tax paid by S within three years of D's death. According to the government the form of the transaction should not prevail over the substance, in this situation because D transferred the funds to S with the understanding the S would use the money to make gifts and then to pay their gift tax liabilities.

(B) Quaere, however, whether the legislative history of §2035(b)., which makes it clear that any gift tax paid by S on S's share of any gifts made by D and split by S is not includible under the gross up rule. H.R. Rep. No. 1380, 94th Cong., 2d Sess. 14 (1976), 1976-3 C.B. 735, 748. Should only half the gift tax be returned to D's gross estate, leaving excluded S's payment of half the tax on the half that S is deemed to have given by virtue of the gift splitting election? Presumably the government's litigation position will be that, notwithstanding the check written by S, effectively D paid all the gift tax on the split gifts; S effectively made none of the gifts and paid none of the tax, so the rule relating to payment simply does not apply.

v) An interesting question is whether the decedent in this type of situation could impose the gross up rule estate tax liability on the donees as a form of net gift, applicable as a condition on the gift itself if the decedent dies within three years of the gift. If so, quaere whether this conditional liability would reduce the value of the gifted property for gift tax computation purposes, thereby also reducing the gross up rule estate tax.

(A) A useful analogy might be to a decedent who made no transfers and instead died with all the gifted property, which passes to the same beneficiaries at the decedent's death. Any tax liability incurred in that case would reduce the amount received by the donees but would not reduce the value of the decedent's gross estate for estate tax computation purposes.

(B) It seems unlikely that a court would accept a different effective result if the decedent made the transfers as death bed gifts, given the fact that §2035(b) is designed to eliminate any advantage of planning to pay gift tax on transfers made in contemplation of death.

3. <u>Benefit of Rates</u>. The client also should consider whether the effect of any differentials in the rate of state wealth transfer tax imposed on the estate (based on degrees of consanguinity of the various takers) should be preserved to the benefit of the respective takers. This issue is addressed in the sample tax clause found beginning at page 127, paragraph 1.2.3.6.

a. A spouse typically enjoys this benefit through equitable apportionment (although some states still do not recognize that doctrine).

b. The benefit of a lower rate for children or descendants as opposed to more distant relatives or strangers also is preserved under some states' laws, including under the Uniform Estate Tax Apportionment Act.

c. An easy, common example of a situation in which this might be relevant is the client with children and step-children who the client wants to benefit equally. In some states the step-children would bear a larger share of the state wealth transfer tax burden if the state imposes a higher tax rate on step-children than it does on natural born or adopted children.

d. Because the computation necessary to allocate rate differentials is not easy, the client may wish to alter the normal apportionment rule. Indeed, even if preservation of this apportionment rule is the intent, it might be possible to do so in an easier and roughly comparable manner by adjusting the size of various shares or bequests (taking into consideration the effect of state taxes and the beneficiary's relation to the client) and override the state apportionment rule.

4. Shifting Beneficial Interests. The immediately foregoing discussions should underscore the fact that apportionment of taxes can work a "tax free" shift of wealth among various beneficiaries of a decedent's estate.

   a. One way to shift wealth as part of postmortem planning is to apportion (or waive the apportionment of) taxes.

   b. In fact, it may be possible to generate an income tax deduction for a beneficiary who pays taxes properly allocable to another, if the individual liable for payment refuses to pay, creating a §166(d)(1) bad debt deduction for the party who bears the added tax. See Rev. Rul. 69-411, 1969-2 C.B. 177. Income or gift tax consequences of such a refusal and payment should, however, be evaluated before attempting such ploy.

5. Generation-Skipping Taxes. Generation-skipping taxes are a major tax allocation concern.

   a. For example, allocation of the generation-skipping tax exemption may have inequitable tax consequences to otherwise equally situated beneficiaries due to the way the generation-skipping tax burden falls.

   b. Many estate plans anticipate this inequity by inclusion of a generation-skipping tax clause, dictating that taxes incurred on a taxable distribution shall be paid by the trust (rather than by the beneficiary upon whom that tax otherwise would fall), notwithstanding the fact that this tax payment is itself an added taxable distribution that is subject to the generation-skipping tax under §2621(b). See Treas. Reg. 26.2612-1(c). This issue is addressed in the sample tax clause found beginning at page 127, paragraph 1.1.2.

(1) Because that additional distribution is deemed to occur on the last day of the year of the actual distribution, the total distribution for the year requires an interrelated or algebraic computation to determine the tax on the actual distribution, and then the tax on the deemed distribution in the amount of that tax, and on any additional deemed distribution to cover that tax, and so on, all in the year of the original distribution.

(2) The algebraic formula to determine the total distribution, actual and deemed, against which the tax applies, is:

total distribution = actual distribution ÷ (1 – rate of tax)

For example, if the actual distribution in 2005 was $100,000 and the tax rate was 47%, the trustee's payment of the tax on that $100,000 actual distribution would be another $88,679, computed as $100,000 ÷ (1 - .47). As verification: total actual and deemed distributions of $188,679 × .47 tax yields $88,679 in tax that goes to the government and leaves $100,000 that went to the beneficiary.

c. In addition, the instructions to Form 706-B under the 1976 tax provided that, if the generation-skipping tax paid by a generation-skipping trust upon termination of an interest were paid from a portion of the trust not the subject of the termination, that tax payment would constitute an additional taxable termination. Although that position is not explicitly stated on the current version of Form 706 Schedule R, it is a proper result and could be important in group trusts, which should insure that taxes paid are allocated to the respective share(s) subject to tax (unless the §2654(b) separate share rule applies and the terms of the document do this automatically).

d. In the case of QTIP property includible in the estate of a surviving spouse under §2044, payment of tax (either directly or pursuant to §2207A) may exhaust assets as to which a §2652(a)(3) allocation of exemption had been made, essentially wasting a portion of that exemption.

(1) If §2207A is waived, or if the settlor of the QTIP trust directed that all taxes on QTIP property should be paid from any portion of the QTIP that was not made exempt by an allocation under §2652(a)(3), Treas. Reg. §§26.2652-1(a)(3) and 26.2652-1(a)(6) *Examples 7* and *8* establish that this relief of the exempted QTIP trust from its §2207A reimbursement obligation does not constitute a constructive addition to

the trust for generation-skipping transfer tax purposes because, due to the reverse QTIP election, for generation-skipping transfer tax purposes the property is treated as the original transferor's, not as the spouse's, notwithstanding inclusion in the surviving spouse's gross estate. As a result, §2207A also is deemed not to apply, meaning that there can be no constructive addition. To the same effect with respect to chronologically exempt QTIP trusts are Treas. Reg. §§26.2601-1(b)(1)(iii)(A) and 26.2601-1(b)(1)(v)(C).

(2) The express language of §2652(a)(3) supports this result, it specifying that, if the election under this section is made, then "for purposes of [chapter 13, the result is] as if the election to be treated as qualified terminable interest property had not been made" by the settlor of the trust.

(a) The non-addition position is that, lacking a QTIP election, there would be no §2044 inclusion in the surviving spouse's gross estate, and no §2207A right of reimbursement.

(b) Thus, for generation-skipping transfer tax purposes this trust should be regarded as nontaxable at the surviving spouse's death; thus, there is no tax burden properly allocable to the trust, meaning that waiver of §2207A or any other apportionment provision is no "benefit" to the trust for purposes of the tainting addition question under chapter 13. And it does not matter whether the surviving spouse waives the right of reimbursement or the personal representative fails to assert it.

(3) This rationale leaves it open for the government to allege that failure to assert the §2207A right of reimbursement in a normal QTIP trust is a constructive addition by which the spouse's beneficiaries become the generation-skipping transferors. As illustrated in Treas. Reg. §26.2652-2(d) *Example 3*, this is relevant for purposes of determining the transferor of the §2207A reimbursement amount and, although not stated, the gift tax treatment under Treas. Reg. 20.2207A-1(a) may make the beneficiaries who are deemed to make a gift by failing to assert the right of reimbursement the transferors to that extent, rather than the surviving spouse. This treatment would be consistent with Treas. Reg. §26.2601-1(b)(1)(v)(C), which regards failure to assert the §2207A right of reimbursement as a constructive addition for purposes of the transition date rules that exempt chronologically advantaged trusts.

(4) Outside the chronologically exempt QTIP or the reverse QTIP election situation, Estate of Boyd v. Commissioner, 819 F.2d 170 (8th Cir. 1987)

(waiver of §2206 right of reimbursement deemed to be a form of "bequest" that the beneficiary of insurance proceeds could waive), as discussed at page 22, also supports the result that waiver of any right of reimbursement is a form of bequest that could constitute a tainting addition to an otherwise exempt QTIP trust. And the government's rationale with respect to the reverse QTIP, that no reimbursement right exists because of the reverse QTIP election, makes it more likely that the constructive addition result will obtain in cases in which the reimbursement right clearly exists.

e. A similar issue reflects the fact that, under §2603(b), generation-skipping taxes are apportioned to the property "constituting" the generation-skipping transfer.

(1) If a trust is partially exempt, use of general trust assets to pay taxes on a taxable termination may serve to waste partially exempt assets in payment of generation-skipping taxes.

(2) Section 2653(b)(1) provides that "[u]nder regulations prescribed by the Secretary . . . proper adjustment shall be made to the inclusion ratio with respect to such trust to take into account any tax under this chapter borne by such trust which is imposed by this chapter on the transfer . . . ." It is not clear what this means and it appears that the regulations provide no guidance.

(3) Because the inclusion ratio operates in a partially exempt trust to make part of every asset "exempt" and part taxable, it is not possible to apportion the tax within such a trust to only wholly taxable assets. Thus, some of the exemption is wasted with respect to every dollar of trust property used to pay generation-skipping transfer taxes.

(4) The easy solution to this problem is to create two trusts, one that is totally exempt and one that is totally taxable, with all tax inclusion and apportionment being limited to the totally taxable trust.

(5) Another solution is a "net gift" type of approach by which the beneficiary of a generation-skipping trust directs his or her estate to pay any generation-skipping tax incurred by reason of that beneficiary's death.

(a) Assuming this tax payment is a constructive addition by the beneficiary, the result is to preserve the partially exempt assets but effectively decrease the exempt portion by virtue of the constructive addition.

(b) Mathematically, however, this constructive addition result may be better than use of partially exempt dollars to pay the tax directly, as illustrated by the following example.

(c) Assume the trust is $10,000,000 and the applicable fraction is one-fourth, making $2,500,000 of the trust "exempt." Because the exemption actually is built into the inclusion ratio, which reduces the tax rate, the effect is to reduce the tax rate to 75% of the 47% impost in 2005, meaning that a generating-skipping tax of $3,525,000 would be incurred at the beneficiary's death, leaving $6,475,000 in the trust, still (unless the §2653(b)(1) regulations provide otherwise) one-fourth ($1,618,750) "exempt."

(d) If, instead, the constructive addition approach were followed, a new fraction would be struck of $2,500,000/13,525,000 and the new fraction would produce an "exempt" portion of 18.48428% ($1,848,428 out of the *actual* fund of $10,000,000).

f. Finally, §2612(a)(2) needs to be considered. Applicable in the context of a trust with several beneficiaries and staggered distributions, this provision specifies that distributions that are not due to the death of a lineal descendant of the transferor are taxed as taxable distributions, not as taxable terminations of that beneficiary's interest in the trust.

(1) The effect for tax apportionment purposes is on the source of tax payment — the tax being imposed on the beneficiary instead of on the trust. In many cases this probably is the most equitable form of tax apportionment.

(2) If §2612(a)(2) does not dictate taxable distribution results, however, because a partial termination occurs on the death of a lineal descendant of the transferor, then an inequity may arise because taxable termination treatment causes the tax liability to befall the trustee.

(3) Unless this tax is allocated to the portion that terminated (for example, as a charge against the distributable share), the effect is that all beneficiaries of the trust pay the tax on a termination that provides a partial distribution to only one of the trust's beneficiaries. This is inequitable and likely not the transferor's intent.

(4) Here an appropriate fix could include dictating generation-skipping tax apportionment either to the trust in all events or to the distributees in all events, regardless of the operation of §2612(a)(2).

6. Section 303. The effect of apportionment under state law or by virtue of provisions in the estate plan should be considered in conjunction with §303 if sale or exchange treatment on redemption of §303 stock is to be obtained.

   a. By virtue of §303(b)(3) and Treas. Reg. §1.303-2(f), the dividend avoidance benefits of §303 are available only to the extent the owner of the stock redeemed bears the burden of estate taxes and administration expenses of the estate.

   b. If those burdens do not fall on that stockholder, the benefits of §303 may be lost, a result that may be avoided through effective allocation of those burdens.

7. Income and Principal Rules. Finally, in considering tax payment and apportionment of the burden, an income and principal rule should be kept in mind.

   a. Typically estate income earned on assets that are expended for tax payment purposes remains income in the estate. See, e.g., Uniform Principal and Income Act (1997 Act) §201(2)(A), 7B U.L.A. 13 (Supp. 1999), and Revised Uniform Principal and Income Act (1962 Act) §5(b), 7B U.L.A. 160 (1985). An extreme example that illustrates this rule is Union Planters Nat'l Bank v. Dedman, 1998 Tenn. App. LEXIS 9, in which the tax payment provision placed the burden on the residue of the probate estate without apportionment and taxes attributable to nonprobate property exceeded the value of the estate as determined at the date of death. There was sufficient postmortem income and capital appreciation, however, to satisfy the tax payment obligation but the court held that postmortem income was payable to the residuary beneficiary under what it called the "Massachusetts" rule that the income beneficiaries enjoy the income from the entire residue and not just the income from whatever corpus remains after satisfaction of all payments from the residue. The result is counterintuitive in that it assumes there to be residuary income even though there is no residue, although it correctly reflects that, prior to payment of these estate charges, there is the possibility for investment returns to the estate that must be considered in drafting those provisions that dispose of the estate.

   b. A will may, however, direct that this income be added to principal to help compensate for the diminution caused by tax payment.

   c. Alternatively, the will could provide that the income also be used to pay taxes, in either event shifting a part of the burden of tax payment to the income beneficiaries. But consider the *Hubert* issue discussed beginning at page 49.

IV. Drafting Considerations.

A. Presumption Favors Apportionment. Drafters should be mindful that equity favors equality; if the provisions of an estate plan are ambiguous, the presumption favors apportionment of taxes to achieve equality. Unfortunately, sometimes the document is all too clear.

1. To illustrate, consider the decedent's tax payment provision involved in Technical Advice Memorandum 9434004. This classic burden on the residue clause waived all rights of reimbursement and was deemed to override state apportionment rules that would have pro rated the tax liability against includible nonprobate properties.

   a. After making several preresiduary bequests, the will divided what it referred to as the residue into a formula bequest that it described as "the exemption equivalent of the maximum unified credit allowable in determining the federal estate tax on my gross estate" and left the residue of the residue to a marital deduction trust.

   b. The formula bequest made reference to the preresiduary bequests passing under the will that did not qualify for the marital deduction but did not indicate that it also should have been reduced by the includible nonprobate assets or inter vivos gifts that consumed a portion of the decedent's unified credit because they too did not qualify for the marital deduction. As a result, the formula bequest called for an amount that was larger than the amount that could be sheltered from tax payment by what remained of the decedent's unified credit and taxes were incurred that were payable from the marital deduction residue.

   c. This reduced the estate's marital deduction, which increased the tax liability that also was payable from the marital bequest, resulting in a circular whirlpool computation of the decedent's estate tax liability. In addition, because of the inter vivos transfers, the nonprobate includible assets, and the improperly described formula bequest that totaled more than the $600,000 exemption equivalent at that time, and a marital deduction that did not eliminate taxes in this estate, the marginal estate tax bracket in which the estate was taxable was higher than the 37% marginal rate that normally was applicable in computing the "exemption equivalent" of the $192,800 unified credit that applied at that time.

   d. This created its own circular computation because, at a higher marginal rate, less than $600,000 of total taxable property generates the same $192,800 of tax liability ("exemption equivalent of the unified credit" applicable in that estate), which caused the formula bequest to be smaller, resulting in a greater residue of the residue qualifying for the marital deduction. This produced slightly less tax and therefore a slightly larger marital deduction as a result of its own secondary circular computation, and that again affected the exemption equivalent computation, setting off another round of interrelated computations.

2. Either the tax payment dictate or the formula bequest alone would have been significant defects in effective estate planning. Together they created a swirling stew of tax computation and payment complexity that, coupled with other demonstrable blunders in the decedent's will revealed in the abbreviated facts of the Ruling (including blanket exercise of powers of appointment by the residuary provision and a bequest to "my children in equal shares per stirpes"), presented a bewildering array of opportunities for potential litigation against the drafter's malpractice liability insurer.

B. <u>Waiving Rights of Reimbursement</u>. This is so important that it ought to come first in thinking about drafting.

1. Sections 2206, 2207, 2207A, 2207B and, in its special way, §2603(b) all create a right of reimbursement for taxes caused by an individual's death (or a generation-skipping taxable event). Inadvertent waiver of these rights could be calamitous.

    a. Given all the other property that might generate taxes and the possibility that there will be insufficient assets otherwise available to pay taxes under normal apportionment rules, loss of these reimbursement rights as a source of funds could create severe problems. It is in reflection of this fact that §§2207A and 2207B require waiver of their rights of reimbursement to constitute a specific indication of intent to waive reimbursement to be effective.

    b. Note, however, that apportionment is better than reimbursement, for liquidity purposes, because apportionment forces the recipient of property to make the initial payment while reimbursement requires the estate to pay up front and then seek a recovery of the expended assets. This issue is addressed in the sample tax clause found beginning at page 127, paragraph 1.3.

    c. Liquidity and the apportionment/reimbursement issue is particularly important in a tax environment that includes chapter 14 and state death taxes that could exceed the amount of a bypass trust, even in an otherwise nontaxable optimum marital deduction situation.

        (1) If this occurs, marital deduction property may be needed to pay taxes, which will generate a loss of deduction and a corresponding imposition of federal estate tax, with the need to further invade the marital to pay

those taxes, with a corresponding loss of more deduction, resulting in a whirlpool computation effect.

(2) To the extent the marital bequest does not fully work to zero out state taxes even equitable apportionment cannot protect against this result.

d. On the generation-skipping side of this issue, Congress was well advised to presume against waiver of the reimbursement right by requiring a specific reference to chapter 13 to work a negation of §2603(b). Without this requirement, inadvertent and serious consequences could attend an innocent provision included in a tax clause with no conscious intent to impose the generation-skipping tax on a decedent's estate.

e. In addition, waiver of §2207A reimbursement should be considered carefully because the regulations under §2207A provide that the simple failure to enforce the right of reimbursement is a gift (neither of §§2206, 2207, nor 2207B so provide).

(1) This liability (which often will be unexpected and the beneficiaries deemed to have made the gift likely being without knowledge that the gift was even made) can be avoided if the surviving spouse as beneficiary of qualified terminable interest property waives the §2207A right of reimbursement.

(2) It is particularly important that the surviving spouse have the flexibility to decide whether to preserve or waive this right of reimbursement; normally, the qualified terminable interest trust should specify that taxes attributable to trust property will be paid from the trust before it pours over into a bypass trust (or otherwise is distributed) unless the surviving spouse's will overrides that direction by a provision making specific reference to the QTIP trust.

(3) With respect to the requisite indication of intent required under §2207A itself, consider In re Will of Gordon, 510 N.Y.S.2d 815, 817 (Sur. Ct. 1986), in which the decedent's tax clause read "I direct that all . . . taxes . . . imposed . . . by reason of my death with respect to any property includable in my estate . . . whether such property passes under or outside my will be paid out of my Residuary Estate . . . without apportionment."

(a) If the court had found the §2207A reimbursement right had been waived by this provision, a charitable residuary bequest would have abated completely.

(b) The court found that this provision was not adequate to work such a result. To the same effect was In re Kramer, 610 N.Y.S.2d 31 (App. Div. 1994), which held that a direction to pay from the residue of the decedent's estate all estate taxes except those attributable to property includible in the decedent's gross estate under §§2035, 2039, and 2041 was not sufficient to overcome the statutory requirement for specific reference to waive the §2207A right of reimbursement. As a result, the decedent's daughter by a prior marriage was not burdened with taxes caused by inclusion of QTIP marital deduction trust property that passed to children of the decedent's predeceased husband by his prior marriage.

(c) The subsequent amendment to §2207A now will generate the same result nationwide, matching in principal a change to New York law, E.P.T.L §2-1.8(d-1) (1992), providing that a general direction in a will to pay all taxes imposed on account of the testator's death is not applicable to taxes imposed at the death of the surviving spouse as beneficiary of a QTIP trust unless the will specifically provides otherwise. But see In re Estate of Beebe, 702 N.Y.S.2d 683 (App. Div. 2000), in which the provision stated that "there . . . be no proration or apportionment" of taxes among the residuary beneficiaries, on whom the tax burden fell, notwithstanding that some were charitable beneficiaries to whom state law equitable apportionment otherwise would apply.

(d) Other similar state statutes now include Mich. Comp. Law Ann. §700.133a(3) (1995) (decedent must "expressly manifest" an intent that taxes imposed under §2044 be paid by decedent's estate); N.C. Gen. Stat. §28A-27-2(b) (1994) (general direction to pay all taxes from decedent's estate without specifically stating otherwise does not waive reimbursement under §2206, §2207, or §2207A); Ohio Rev. Code Ann. §2113.86(I) (1995) (requiring reference to either §2044 or its state law counterpart, or to qualified terminable interest property); 20 Pa. Cons. Stat. §3701 (1995) (waiver must expressly refer to §2207A right of reimbursement).

(e) Other courts reached the same nonwaiver conclusion without the benefit of state law, although the predictability of result in this respect is quite low.

    i) See, e.g., In re Maurice F. Jones Trust, 637 N.E.2d 1301 (Ind. Ct. App. 1994) (direction to pay all estate taxes assessed "by reason of my death . . . which I am legally obligated to pay at the time of my death . . . without apportionment" deemed ambiguous with respect to taxes caused by inclusion of QTIP trust property; extrinsic evidence allowed to establish that decedent did not intend to exonerate the remainder beneficiaries of the QTIP trust who were relatives of the decedent's predeceased spouse and charities and burden the decedent's residuary beneficiary, who was the decedent's child by a prior marriage; notice also that the tax payment direction mentioned apportionment but not the §2207A right of reimbursement, which could have been relied upon as well); Firstar Trust Co. v. First Nat'l Bank, 541 N.W.2d 467 (Wis. 1995), aff'g in part and rev'g in part 525 N.W.2d 53 (Wis. Ct. App. 1994) (will directing payment of all taxes "payable by reason of my death" and that would have exhausted funds otherwise passing to charity deemed insufficient to require payment of federal estate tax attributable to inclusion of QTIP trust property because that tax was caused by reason of the decedent's predeceased spouse's death; the general tax payment provision was not a sufficient clear and specific direction to overcome §2207A — although it *was* adequate to leave unchanged the state law burden on the residue for the Wisconsin estate tax attributable to the QTIP trust).

ii) See also In re Marital Deduction Trust under Will of Adair, 695 A.2d 250 (N.J. 1997), in which it was the state pick up tax attributable to the inclusion of a QTIP trust in the decedent's gross estate that was the subject of an inartful trust provision calling for distribution to the decedent's probate estate of any amount the decedent's personal representative determined "to be required for the payment of taxes payable by reason of my death." The trust made reference to "all property comprising [the decedent's] gross estate . . . whether or not such property passes hereunder," which arguably was a waiver of state law apportionment to the nonprobate QTIP trust, but the court concluded that, among other things, the decedent's tax payment provision was "generic, boilerplate" that did not "evince a clear and unequivocal intention" to direct against state law apportionment of the tax burden to nonprobate property, and that the word "required" could only be taken to mean that the decedent was directing payment of taxes that the probate estate was legally obligated to pay and these were a legal obligation of the QTIP trust itself absent a clear direction to the contrary.

iii) Cf. In re Estate of Tubbs, 900 P.2d 865 (Kan. Ct. App. 1995) (Kan. 1995) (specific reference required by §2603(b) to waive apportionment of generation-skipping transfer tax not met by general references to estate, inheritance, and death taxes; required is that the generation-skipping transfer tax be mentioned explicitly); Estate of Monroe v. Commissioner, 104 T.C. 352 (1995) (reference to federal estates taxes or other death taxes not adequate to constitute §2603(b) specific reference.

(f) For comparison purposes.

i) In a case involving waiver of §2206 and 2207 and no "special" remainder beneficiary, the following language was adequate to waive those rights of reimbursement: "All estate taxes payable by reason of my death shall be chargeable against and payable out of my residuary estate without contribution by anyone." In re Bruce, 516 N.Y.S.2d 748 (A.D. 1987) (notwithstanding the drafter's testimony that the decedent and the drafter were unaware of nonprobate assets and that the purpose of the provision was to avoid inside apportionment only).

ii) Similarly, in a case involving children by two marriages and waiver of §2206 but not §2207A, the following language was deemed adequate to preserve the latter and waive the former: "my personal representative shall . . . pay from the residue of my estate all estate and inheritance taxes assessed by reason of my death other than those related to qualified terminable interest property contained therein." In re Estate of Tovrea, 845 P.2d 494 (Ariz. Ct. App. 1992). Very similar language produced the same §2206 waiver in Emmertz v. Cherry, 520 S.E.2d 219 (Ga. 1999).

iii) Estate of Vahlteich v. Commissioner, 67 T.C.M. (CCH) 2704 (1994), rev'd in an unpublished opinion, 95-2 U.S. Tax Cas. (CCH) ¶60,218 (6th Cir. 1995), involved a charitable bequest and a tax payment provision calling for payment of "all transfer, estate or inheritance taxes . . . without apportionment" and a state law calling for outside apportionment unless the decedent referred specifically to the statute "or to qualified terminable interest property." Lacking the statutory requisite of a reference to either §2044 or its state law counterpart, or to qualified terminable interest property, the court on appeal concluded that the Tax Court's holding that the decedent's will waived the QTIP trust's §2207A and state law equitable apportionment share of the estate tax liability of the decedent "is wrong in its reading of [Ohio Rev. Code Ann. §2113.86(I)] and doubly wrong in not reflecting the proper policy of the State" to preclude inadvertent exoneration of QTIP trust property, especially if the result is that residuary charitable beneficiaries receive less and taxes are increased unnecessarily: "This is simply counterintuitive on its face and counter to a presumption in Ohio law that a testator intends to maximize deductions and pass as much to chosen beneficiaries as possible."

(4) As a matter of routine, similar results should be expected under §2207B with respect to property that is includible in a decedent's gross estate under §2036. Compare Technical Advice Memoranda 199918003 and 199915001 (typical pay-all-taxes-from-the-residue provisions with nonspecific waiver of reimbursement language were inadequate to override §2207B, notwithstanding that, in the earlier case, the same language *was* sufficient to waive reimbursement rights under §2206 with respect to an insurance trust that was includible by virtue of §2035) with Myers v. Ellerbusch, 746 N.E.2d 408 (Ind. Ct. App. 2001) (corporate fiduciary's formbook tax payment direction to pay

> all estate and inheritance taxes assessed by reason of my death whether with respect to property passing under this Will or property passing otherwise than under the Will and whether such taxes be payable by my estate or by any recipient of any such property. I waive for my estate all rights of reimbursement for any payments made pursuant to this item

was deemed adequate to waive the §2207B reimbursement right notwithstanding the lack of any reference to §2036 includible property or to §2207B). Some refinement may be required by virtue of the fact that the specific reference requirement originally part of §2207B was moderated to make it identical to that added to §2207A in 1997; case law decided based on the different rules before these provisions were coordinated might produce different results. Decided without having to evaluate the §2207B specific reference or specific indication of intent requirement, In re Estate of Meyer, 702 N.E.2d 1078 (Ind. Ct. App. 1998), makes note of this change in the law. Arzt v. Savarese, 36 F. Supp. 2d 653 (D. Del. 1999), held it to be determinative because both includible trusts long predated the December 17, 1987 effective date of §2207B.

(5) Although there is yet no authority for the proposition, it seems likely that the government will provide in regulations that failure to assert the §2207B right of reimbursement also constitutes a gift, but that this consequence may be avoided by an effective waiver of the right itself— which will require a specific indication of intent to be effective.

2. <u>With respect to Chapter 14</u>:

   a. Section 2701(d) presents difficulty because it is not clear who "benefits" by virtue of the deemed transfer attributable to unpaid "suspense account" dividends. Therefore, if outside apportionment exists under state law it is unclear who should pay any tax incurred under this provision.

      (1) Because the value of the unpaid dividends may be included in the value of the underlying stock and, to that extent, will not be subjected to a separate tax under §2701(d), this issue may resolve itself in all but the more unusual valuation situations.

      (2) If it does not, payment of the tax attributable to the suspense account from the residue may be inappropriate and thought should be given to whether the donee of junior equities or the entity should pay the tax attributable to this account. State law outside apportionment is unlikely to answer this question.

   b. Under §2702, a personal residence GRIT, a qualified interest, or a joint purchase that is treated as a split interest trust, may trigger §2036(a)(1) inclusion if the decedent's interest does not terminate before death. In each case inclusion should cause §2207B or outside apportionment to apply.

   c. Section 2703 raises the prospect of estate tax inclusion at a value that is higher than the striking price under a buy-sell agreement. Conceivably the buyer could be regarded as an estate beneficiary to whom taxes attributable to this value differential should be apportioned, although the absence of an agreement anticipating this result is sure to generate litigation. See, e.g., In re Estate of Kapala, 402 N.W.2d 150 (Minn. Ct. App. 1987) (insurance that funded a buy-sell agreement generated tax in the decedent's estate that was apportioned to the buyer notwithstanding argument that the buy-sell agreement established the total liability of the buyer and was silent on this issue; apportionment under §2206 was not a determination that the buy-sell agreement produced a benefit like a specific or general bequest that caused apportionment to the buyer), Estate of Benton, 215 N.W.2d 86 (Neb. 1974), and In re Estate of Galewitz, 160 N.Y.S.2d 564 (App. Div. 1957) (both similarly treating buyers as estate beneficiaries, liable for pro rata taxes attributable to the imputed benefit received); but see In re Estate of Saylors, 671 N.E.2d 905 (Ind. Ct. App. 1996) (purchasers not liable for inheritance tax attributable to farm valued at $281,000 but acquired under option to purchase for $1,000; tax payment provision waived all apportionment and, even if apportionment applied, court regarded the estate as including the proceeds and not the farm).

d. Finally, §2704 poses a problem similar to that under §2701(d) because the deemed transfer attributable to the lapse or imposition of a restriction has no readily apparent transferee to whom the tax generated should be apportioned. The logical source for payment of the tax is the property as to which the restriction applies.

C. Items to Consider. A good tax clause clearly will address the following topics — even if state law is clear on many issues, because of the migratory nature of clients and the potential conflict of laws problems that could arise.

1. Which taxes are being apportioned (estate, generation-skipping, state, or any income taxes).

2. Both inside and outside apportionment, or the waiver thereof, clearly should be covered; often only outside apportionment is contemplated and statutory inside apportionment across the entire estate is forgotten.

3. Equitable apportionment should be considered; it usually will be the client's intent to embrace it, even if no other form of apportionment is desired.

4. Any intent to preserve the effect of state wealth transfer tax computation differentials (if any) should be stated clearly.

5. Any desire to allocate credits to recipients of assets to which they relate should be clear.

6. Alteration of the apportionment rule relative to split or temporal interests always should be considered, particularly in estates with annuity or installment payouts of employee benefits.

7. The tax clause should apportion or call for payment of interest and penalties in the same manner as the taxes to which they relate.

8. If it is known that there will be deductible claims against the estate, such as pursuant to a prenuptial or separation agreement, and they are similar to or in lieu of bequests from the estate, the determination of the size of those dispositions and apportionment of taxes thereto should be considered and specified in the tax clause, frequently applying the same considerations discussed above with respect to other bequests. Especially sensitive, however, is whether the agreement permits apportionment and whether various issues noted here were considered in the preparation of that agreement.

9. Finally, if it is appropriate to look to particular assets first for tax payment, this should be specified.

a. Rather than relying on the personal representative to ferret out the decedent's intent after death, the desire to preserve certain assets should be noted.

b. However, as illustrated by Estate of Reno v. Commissioner, 945 F.2d 733 (4th Cir. 1991), rev'g (en banc) 916 F.2d 955 (4th Cir. 1990), which *aff'd* 51 T.C.M. (CCH) 909 (1986), stating a preference to protect certain assets probably should not be allowed to override other presumably more important apportionment principles. For example, in *Reno*, the preference for preservation of farm property was alleged to cause marital deduction property to be tapped for tax payment; if correct, the tax payment provision would have negated the concept of equitable apportionment and generated a tax because the marital would have been reduced.

D. Pro Rata or Incremental Apportionment. Incremental apportionment (like reimbursement under §2207A) may be desirable because a proportionate amount of all taxes in the estate (which is the §§2206, 2207, and 2207B approach) may nearly bankrupt a small probate estate that is taxed along with massive amounts of nonprobate property (such as a huge §2056(b)(5) power of appointment marital deduction trust).

1. A change to incremental apportionment (deviating from the pro rata approach dictated by most state statutes and by §§2206, 2207, and 2207B) probably is permissible; the tax clause simply should call for apportionment of the amount by which the decedent's taxes were increased by virtue of nonprobate assets being included in the estate.

2. If there are several nonprobate items as to which incremental apportionment is to apply, the tax clause must specify the manner in which they will be considered for allocation purposes.

a. For example, if there were a marital deduction trust and substantial employee benefits causing inclusion, the planner should consider whether either should be deemed included before the other for computation of the taxes caused by inclusion of each.

b. Alternatively, they could be aggregated and the total increase in tax caused by both then prorated between them. This might be appropriate if the remainder beneficiaries of each differ and the incremental tax burden should be shared pro rata by all. This issue is addressed in the sample tax clause found beginning at page 127, paragraph 1.2.2.

c. A third alternative would be to apportion taxes to each nonprobate asset as if the subject asset were taxed *last*, thereby imposing on the aggregate of the nonprobate property a larger share of taxes than either a pro rata share or the aggregate incremental share of tax.

E. <u>If Apportionment Is Preserved</u>, the order for computation of any bequest or share of the estate and for payment of taxes should be specified if it is not clear under state law.

1. It is surprising how seldom this is done, given the number of cases revealing that the proper method frequently is unclear.

2. Thus, for example, if a net estate division in computing a marital deduction fractional share is desired, this should be specified clearly.

F. <u>Be Wary of Discretionary Reimbursement</u>. Unless a fiduciary's overriding duty to maximize the estate is waived, a right to allocate taxes is probably a duty instead, meaning it is not discretionary at all.
meaning it is not discretionary at all.

1. If the duty to maximize the estate *is* waived, it probably is wise to specify the factors to be considered by the fiduciary in deciding whether to seek reimbursement, in which case "discretion" may approach a mechanical application of the relevant factors.

2. If discretion *is* granted, be certain the fiduciary knows the tax consequences of a failure to seek reimbursement (for example, under §2207A) and the income tax consequences of exercising discretion; it may be wise to spell them out in a letter to be included with the estate plan.

3. Finally, consider conflicts of interest that may affect the exercise of fiduciary discretion: is the personal representative personally interested in the outcome of the discretionary apportionment?

G. <u>Coordinate Multiple Tax Clauses</u>. As frequently occurs, it is likely that several tax clauses will (or should) be involved if the client has a funded living trust and perhaps an irrevocable insurance trust in addition to a will directing disposition of the probate estate.

1. To the extent those clauses differ or are contradictory, most decisions indicate that the provision in the will controls.

   a. See, e.g., Estate of Bradford v. Commissioner, 84 T.C.M. (CCH) 337 (2002), Estate of Fagan v. Commissioner, 77 T.C.M. (CCH) 1427 (1999), and Estate of McKay v. Commissioner, 68 T.C.M. (CCH) 279 (1994), all found that the decedents' tax payment provisions (in *Bradford* the provision was an insufficiency tax clause in a trust and a linked will provision that waived all rights of apportionment; the *Fagan* flaw was payment from the residuary estate under a will, with proper apportionment language in a pourover trust that provided for charity; *McKay* provided "that all . . . taxes . . . attributable to my probate estate . . . shall be paid out of the residue of my estate . . . without adjustment among the residuary beneficiaries, and shall not be charged against or collected from any beneficiary of my probate estate"), in each case negated state law equitable apportionment, and thereby caused taxes on the entire estate to be charged to the residue before its division between charitable and noncharitable beneficiaries. The result was a §2055(c) reduction in the charitable deduction for that portion of the residue passing to charities (and an increase in taxes that again reduced the deduction, which further reduced the residue, ad infinitum). See also Estate of Wathen, 64 Cal. Rptr.2d 805 (Cal. Ct. App. 1997) (although trust was silent, will specified that taxes should be paid from the trust, without apportionment, thus overcoming state law pro rata apportionment; court read the will and trust together as if they were one document and allowed the will to govern).

b. But see In re Estate of Pickrell, 806 P.2d 1007 (Ks. 1991), holding that the latter in time controls, that being the trust in that case. As among the other documents, no clear order of priority exists.

c. In re Estate of Patouillet, 601 N.Y.S.2d 385 (Sur. Ct. 1993), involved a will executed before a funded living trust, which benefited different individuals and provided that the trustee was to pay the decedent's executor any amounts designated by the executor as necessary to pay the estate's taxes. The will, however, directed payment of all taxes attributable to nonprobate property and waived all apportionment rights. The court held that, under N.Y. Est. Powers & Trust L. §2-1.8(d)(2), the nontestamentary document that was executed later in time would control and, in this case, that meant the trust would contribute.

2. The Uniform Acts and §§2206 and 2207 all ostensibly require that waiver of apportionment be by a will provision; only §§2207A and 2207B allow waiver by the decedent's revocable trust as well and, although waiver in other tax clauses may not work, it probably can't hurt (unless there is an inconsistency), so touch each base if possible.

   a. For example, in Estate of Roe, 426 N.W.2d 797, 798, 799 (Mich. Ct. App. 1988), the decedent's will provided that "I make no direction for the payment of . . . taxes assessed by reason of my death, as I have provided for their payment under a certain Agreement hereinafter mentioned." The trust called for tax payment and specified that "the Trustee shall not seek contribution from anyone for any portion of the taxes so paid." The court held that apportionment under state law would apply because the will failed to waive application of the state apportionment statute.

b. The court noted that an argument might be made that, although the will failed to prevent apportionment to the trust, the trust waived apportionment so no further allocation of the tax burden from the trustee to other recipients of taxable property would be required. Even if successful, that argument would not be helpful if some of the tax paid by the trust was attributable to other nonprobate assets that was required under state law to pay a proportionate share of the tax burden.

c. The most notable aspect of *Roe* is that the tax clauses involved were verbatim from a major Chicago fiduciary's forms book; this problem exists in literally thousands of estate plans, probably nationwide because of the subsidiaries of the fiduciary that also distribute the form involved.

3. If there is a tax clause in more than one document, and taxes may be paid by more than one entity, clearly specify which goes first or how aggregated apportionment will work.

4. In trusts (such as an irrevocable insurance trust or a grantor retained annuity or unitrust) that are intended to escape inclusion if everything goes as planned, it makes sense to include a safety valve tax clause specifying that:

a. the fiduciary may purchase assets from the grantor's estate or loan money thereto, to provide liquidity; and

b. if any part of the trust is includible in the grantor's estate, taxes caused by inclusion of that portion are payable therefrom.

(1) To work, this probably requires that the grantor's estate plan not waive apportionment with respect to the trust.

(2) Also, the trust document needs to clearly provide that this provision operates only if, quite independently, the trust is found to be includible.

c. Caution: with respect to irrevocable insurance trusts, the last sentence of §2206 presumes that insurance included in a decedent's gross estate will be used first to qualify for any available marital deduction; this means that, if there is a contingent marital deduction provision in the irrevocable insurance trust, principles of equitable apportionment may apply to and override the tax payment provision in the trust.

H. <u>As a checklist</u> of other commonly overlooked apportionment issues discussed above but that always arise, remember to consider:

1. Fees and expenses.

2. State taxes that don't conform to federal estate tax rules and that can produce disparities.

3. Special use valuation and recapture under §2032A.

4. The §2057 family-owned business interest deduction and recapture tax.

5. Section 6163 and future interests that invoke tax; who is to pay the tax thereon?

6. Section 6166 deferral; who is to pay the deferred tax and interest thereon?

7. Estate income tax and Alternative Minimum Tax liabilities.

8. The appreciation estate tax (if adopted).

9. With respect to any apportionment that is preserved, how enforcement will be effected and whether to include a power of set-off in the client's will for any dispositions of probate property to takers of nonprobate property that will bear a share of the tax burden.

I. Clearly Specify Intent. The case reporters are full of decisions involving the meaning of provisions relating to apportionment. A fine illustration of this notion is In re Estate of Siebrasse, 652 N.W.2d 384 (S.D. 2002), labeled a Rehearing of Decision of South Dakota Supreme Court, reversing 640 N.W.2d 747 (S.D. 2002) the court's prior decision in the same case, to establish a "bright line approach" requiring that state law apply unless a tax payment provision "clearly shifts the burden of federal estate taxes from equitable apportionment and clearly identifies the property to which the burden is shifted" using terms that are "specific, clear, and not susceptible of reasonable contrary interpretation."

   1. Clearly state any intent to override any state apportionment rule. For example, do more than just require "payment of all debts and taxes from the residue." See In re Estate of Shoemaker, 917 P.2d 897 (Kan. Ct. App. 1996); First Nat'l Bank v. McGill, 377 S.E.2d 464 (W. Va. 1988).

      a. In Landmark Trust Co. v. Aitken, 587 N.E.2d 1076 (Ill. App. Ct. 1992), litigation was needed to ascertain the decedent's intent because the will simply directed payment of all taxes from the residue, which was insufficient, and it was not clear whether state common law equitable apportionment should apply with respect to the balance. The court determined that state law apportionment was negated entirely by the tax clause and that common law abatement principles were applicable to determine how the excess taxes were to be paid. The result was that general bequests abated while specific bequests were protected from paying their proportionate share of the excess taxes.

b. On the other hand, Barlow v. Brubaker, 465 N.W.2d 276 (Iowa 1991), held that a tax payment provision directing payment from the residue without apportionment did not relieve the recipients of property transferred inter vivos but included in the decedent's gross estate under §2035 from paying their proportionate share of the tax. The estate was insufficient to pay all taxes and the will specified that these inter vivos donees should receive nothing under the will because the decedent had provided for them otherwise. Relief from taxation would have amounted to a testamentary benefit contrary to the decedent's stated intent. See also First Nat'l Bank v. McGill, 377 S.E.2d 464 (W. Va. 1988), and Bunting v. Bunting, 768 A.2d 989 (Conn. App. Ct. 2000), in which the decedent made a sizeable inter vivos gift to a child, as to which the gift tax was less than the available unified credit. At death that gift, added to the taxable estate, caused the remaining property at death to be subject to estate tax in excess of the unified credit. The issue was whether the decedent's direction to pay all taxes from the residue of the estate was meant to apply — given that the residue was less than the combine state and federal taxes due at death. The court concluded that the decedent never anticipated that the inter vivos gift would cause taxes to be generated and therefore could not have intended for the tax payment provision to relieve the inter vivos donee of responsibility to pay estate taxes attributable to inclusion of the taxable gift in the adjusted taxable gifts base for estate tax computation purposes. Therefore, the court apportioned *estate* tax to the donee of that inter vivos gift. In addition to being completely wrong in citing and relying on the §2012 credit for gift tax paid on pre-1977 gifts (the gift in *Bunting* was made in 1988), the dissent argued that the court improperly admitted extrinsic evidence regarding the decedent's understanding of the tax law and the decedent's intent (and that of the drafter of the document). But courts are not alone in making demonstrable blunders in this arena.

c. Two different rounds of litigation with appeals, one through the federal courts and another through the state courts, were required in Estate of Swallen v. Commissioner, 98 F.3d 919 (6th Cir. 1996), rev'g 65 T.C.M. (CCH) 2332 (1993); Matthews v. Swallen, 1995 Ohio App. LEXIS 4669 (Ohio Ct. App. 1995), in which the decedent's irrevocable inter vivos trust was includible in the gross estate and, although it provided for the decedent's surviving spouse, did not qualify for the marital deduction; the residue of the decedent's estate qualified for the marital deduction but only after payment of all taxes and subject to a direction "that no tax . . . shall be charged . . . against . . . any . . . trust beneficiary , so long as the funds or property in the hands of my Executor . . . are sufficient . . . ." Holding that this provision in the will was not adequate to override state law apportionment to the trust, and relying on an income tax provision in the will as stating the decedent's overall intent to minimize taxes, the court on appeal stretched to find the tax payment direction inadequate to impose on the residue the tax liability attributable to the trust and thereby salvaged the marital deduction for the residue.

d. And consider this language from In re Estate of Gerhard, 455 S.E.2d 683 (S.C. 1995): "I direct my executors to pay all . . . taxes imposed upon or in relation to any property . . . required to be included in my gross estate . . . out of my general estates . . . without proration or apportion." Does "general estates" mean the decedent's residuary estate, and does "without proration or apportionment" equate to waiver of reimbursement rights under federal law? The court held yes to the former question (see In re Estate of Cline, 898 P.2d 643 (Kan. 1995) to the same effect, with a lengthy summary of similar cases) but, instead of addressing the latter, determined that state apportionment applied to the extent the residue was inadequate to pay all taxes. It would appear that all taxes that were subject to the §2207 right of reimbursement should have been paid from a trust includible in the gross estate under §2041 (and , had the effective date provision not provided otherwise, that taxes attributable to §2036(a)(1) inclusion of another trust were subject to the §2207B right of reimbursement).

2. For a good collection of cases dealing with sloppy drafting, consult Annot., Construction and Effect of Will Provisions Not Expressly Mentioning Payment of Death Taxes But Relied on as Affecting the Burden of Estate or Inheritance Taxes, 70 A.L.R.3d 630 (1976); Annot., Construction and Effect of Provisions in Nontestamentary Instrument Relied Upon as Affecting the Burden of Estate or Inheritance Taxes, 70 A.L.R.3d 691 (1976); and Annot., Construction and Effect of Will Provisions Expressly Relating to the Burden of Estate or Inheritance Taxes, 69 A.L.R.3d 122 (1976).

3. As an example of how a relatively simple tax clause can create numerous drafting issues, consider a direction "to pay all taxes imposed on my estate by reason of my death."

   a. Does this waive apportionment, or only direct payment of taxes that thereafter may be apportioned?

   b. If the decedent's death is a generation-skipping taxable termination or direct skip, does this assume the burden for those taxes that normally are imposed on the generation-skipping trust or property?

   c. Could this be interpreted to include any additional estate tax imposed under §2032A or §2057 upon a recapture event?

d. Does the reference to "my estate" mean the gross estate, the taxable estate, or the probate estate; both equitable and outside apportionment are involved and not clearly specified.

e. About a shockingly similar provision in the will of one Elmer Cohen, deceased, ("I direct my Personal Representatives to pay, without reimbursement or contribution, all estate [sic], inheritance taxes, and succession duties assessed by reason of my death by the United States or any State thereof"), the Probate Division of the Circuit Court of St. Louis County, Missouri, No. 113549 (April 22, 1996), ruled that the will was "not ambiguous. Ambiguous means reasonably susceptible of more than one meaning. [This provision] is not susceptible of any meaning and cannot be construed." This portion of the holding was overruled on appeal. Estate of Cohen v. Crown, 954 S.W.2d 409 (Mo. Ct. App. 1997), the court refusing to conclude that there was no meaning in the provision, but still concluding that it did not effectively waive the §2206 right of reimbursement with respect to includible insurance proceeds and thereby protecting a charitable bequest that otherwise would have been reduced.

V. Conclusion.

A. As a practical matter, most estate plans probably still waive all apportionment, the effect being that taxes are a burden on the residue as provided under common law.

B. Apportionment rules may create a more equitable method for payment of taxes, and may represent the average decedent's intent when thought is given to the issue; they are not a panacea, however, because they create problems of their own. Even in states with well drafted apportionment statutes (such as either Uniform Act, in most respects), the estate planner always must consider issues relating to the payment of taxes.

VI. Sample Tax Clauses.

A. Much against my better judgment, the following sample tax clauses are offered, for discussion purposes only.

B. The first provision is not as comprehensive as my most recommended provision but may be more readily adaptable to the typical estate plan; it is adapted from the provision found in a major corporate fiduciary's forms book and is designed for use in a trust. The user must remember to incorporate a consistent provision in the client's will and be certain that deviations from state apportionment law are directed in the will (perhaps by reference to the concepts in the trust) to meet the requirement that it be a will that waives apportionment or reimbursement rights. Notice that this provision also contains generation-skipping tax payment and exemption allocation provisions:

> Upon my death the trustee shall pay from the principal of the trust estate the expenses of my last illness and funeral, claims allowable against my estate, costs of administration including ancillary, and estate, inheritance and generation-skipping taxes assessed by reason on my death, except that
>
> > (a) the amount, if any, by which those taxes shall be attributable to property not passing under this trust shall be paid proportionately by the person or persons holding or receiving that property,
> >
> > (b) the amount by which those taxes are attributable to property passing under this trust shall be charged proportionately against the shares or distributions hereafter directed, and
> >
> > (c) the concept of equitable apportionment shall apply so that any deduction or rate differential attributable to the relation of the holder or recipient of property includible in my gross estate and applied in the computation of those taxes shall enjoy the benefit of that deduction or differential.
>
> Interest and penalties concerning any tax shall be paid and charged in the same manner as the tax. The trustee may make payment directly or to the legal representative of my estate as the trustee deems advisable. The trustee shall exercise any available power to apportion taxes directed to be paid by the holder or recipient of property includible in gross estate. To the extent possible, assets or funds otherwise excludable in computing taxes payable by the trustee shall not be used to make the foregoing payments.
>
> The trustee's selection of assets to be sold to make the foregoing payments or to satisfy any pecuniary bequests, and the tax effects thereof, shall not be subject to question by any beneficiary. The trustee shall make such elections under the tax laws as the trustee deems advisable, and shall allocate my generation-skipping tax exemption as it deems advisable, except that the exemption shall be allocated (a) first to property given by me rather than by another or appointed by me, and (b) to a direct skip caused by a disclaimer only if no other allocation is possible. Elections and allocations shall be made without regard to the relative interests of the beneficiaries and shall not be subject to question by any person. No adjustment shall be made between principal and income or in the relative interests of the beneficiaries to compensate for the effect of elections or allocations under the tax laws made by the trustee. My trustee shall not be liable for the effect of elections or allocations made in good faith.
>
> The succeeding provisions of this declaration are subject to this provision.
>
> If a trust hereunder would be partially exempt from generation-skipping tax by reason of an allocation of generation-skipping tax exemption to it, before the allocation the trustee in its discretion may divide the trust into two separate trusts of equal or unequal value, to permit allocation of the exemption solely to one trust that will be entirely exempt from generation-skipping tax. In addition, if a trust hereunder is entirely exempt or nonexempt from generation-skipping tax and adding property to the trust would partially subject it to generations-skipping tax, the trustee in its discretion may hold that property as a separate trust in lieu of making the addition. Except as otherwise provided in this instrument, the two trusts shall have the same terms and conditions but the trustee shall not make discretionary distributions from the income or principal of the exempt trust to beneficiaries who are non-skip persons so long as any readily marketable assets remain in the nonexempt trust.

Upon division or distribution of an exempt trust and a nonexempt trust held hereunder, the trustee in its discretion may allocate property from the exempt trust first to a share from which a generation-skipping transfer is more likely to occur.

If the trustee considers that any distribution from a trust hereunder other than pursuant to a power to withdraw or appoint is a taxable distribution subject to a generation-skipping tax payable by the distributee, the trustee shall augment the distribution by an amount that the trustee estimates to be sufficient to pay the tax and shall charge the same against the trust to which the tax relates. If the trustee considers that any termination of an interest in trust property hereunder is a taxable termination subject to the generation-skipping tax, the trustee shall pay the tax from the portion of the trust property to which the tax relates, without adjustment of the relative interests of the beneficiaries.

C. The next provision is designed for use in a will. It is much more extensive than the prior provision and reflects the thinking I would apply based on the material in this outline. I don't doubt that it is far more complex than the typical user would want to incorporate and may apportion taxes to recipients the client would want to spare. The presumption is in favor of apportionment except to the extent a recipient is absolved. By way of example, many users are likely to delete paragraph 1.2.1.2, requiring apportionment with respect to donees who received gifts during life, because the amounts involved are too small to be concerned with and the hassle of apportionment is too great.

1. Debts, Expenses, and Taxes: My personal representative shall pay from the residue of my estate all obligations of my estate, including expenses of my last illness and funeral, costs of administration (including ancillary), other legally enforceable charges and claims allowable against my estate, and (subject to apportionment as provided below) death taxes as defined next below. Payments may be charged to estate income or principal and deducted for income or other tax purposes in the discretion of my personal representative without regard to whether any other deduction otherwise allowable is reduced.

1.1. Death Taxes Defined: Death taxes means all estate, inheritance, succession, or transfer taxes and any income or similar taxes on appreciation (including interest, penalties, and any excise or supplemental taxes) imposed by the laws of any domestic or foreign taxing authority at the time of or by reason of my death, but shall not include:

1.1.1. Any additional estate tax incurred under §2032A(c) or §2057(i)(3)(F) of the Internal Revenue Code or any similar or corresponding state tax law or any successor provision to any such law, all as amended prior to my death (hereafter collectively referred to as the Code) because of the disposition of or failure to use qualified real property or family-owned business interests; and

1.1.2. Generation-skipping transfer taxes imposed by Chapter 13 of the Code [, except to the extent attributable to a direct skip of which I am the transferor and that is not caused by a qualified disclaimer by a non-skip person (as those terms are defined in the Code), which shall be paid from the residue of my estate without apportionment or reimbursement notwithstanding the provisions of §§2603(a)(3) and 2603(b) of the Code or any other provision of this will].

1.2. Apportionment: Except as otherwise provided herein, it is my intent that each recipient of property that is includible in my estate for death tax purposes (whether passing under this will or otherwise) pay the death taxes attributable to the property (s)he receives, determined as follows:

1.2.1. The death tax attributable to:

1.2.1.1. Appreciation is the full amount of income or similar taxes incurred by reason of my death.

1.2.1.2. Adjusted taxable gifts as defined by §2001(b)(1)(B) of the Code, any gift taxes includible in my gross estate by §2035(b) of the Code, any recaptured inter vivos transfer subject to §529(c)(4)(C) of the Code, or any comparable inclusion (hereafter collectively referred to as completed lifetime gifts) is the difference between (a) the total death taxes incurred by my estate, less those death taxes described in paragraph 1.2.1.1 and (b) the death taxes that would have been incurred if there were no completed lifetime gifts. For apportionment purposes, the recipient of property that produced gift tax includible by §2035(b) of the Code shall be treated as having received the amount of that gift tax, and the recipients of completed lifetime gifts will pay the tax attributable thereto.

1.2.1.3. The death tax attributable to all other property is the difference between (a) the total death taxes paid by my estate and (b) those death taxes described in paragraphs 1.2.1.1. and 1.2.1.2. that actually are collected by my personal representative.

1.2.2. Multiple Recipients: If there is more than one recipient of property separately described in paragraphs 1.2.1.1. through 1.2.1.3, each recipient shall pay a proportionate share of the death tax attributable to all of the property described in that separate paragraph based on the value of the property received by the recipient as finally determined in the death tax computation as compared to the same value of all property described in that separate paragraph that is not excluded from apportionment under paragraph 1.2.6.

1.2.3. Tax Benefits: Credits, deductions, exclusions, exemptions, and similar benefits shall be reflected as follows:

1.2.3.1. In computing the death tax paid by my estate for purposes of paragraph 1.2.1.2. and determining the proportionate share of such tax to be paid by any individual recipient, any gift tax allowed as a credit by §2001(b)(2) that was paid by the recipient shall inure to the benefit of that recipient.

1.2.3.2. In computing the death tax paid by my estate for purposes of paragraph 1.2.1.3. and determining the proportionate share of such tax to be paid by any individual recipient, the credit granted by §2001(b)(2) for gift taxes that were not paid by any individual recipient, the unified credit granted by §2010 of the Code, the credit for gift taxes granted by §2012 of the Code, the credit for property previously taxed granted by §2013 of the Code (but only to the extent attributable to property that cannot be identified specifically as includible in my estate at death), and any other credit the benefit of which is not allocated by paragraph 1.2.3.3. because it is not possible to identify the property passing to a recipient that produced the credit shall inure to the benefit of all recipients of property described in paragraph 1.2.1.3.

1.2.3.3. The benefit of any other credit shall inure to the recipient of property that produced the credit (e.g. the recipient of property that generates a state death tax shall enjoy the benefit of the credit granted by §2011 or the deduction granted by §2058 with respect to payment of that tax, the recipient of property subject to foreign death tax shall enjoy the benefit of the credit granted by §2014 with respect to the taxation of that property, and the recipient of specifically identifiable property that is includible in my estate and that previously was taxed shall enjoy the benefit of any credit granted by §2013 with respect to that property).

1.2.3.4. The benefit of any reduction in tax attributable to an election under §2032A of the Code shall inure to the qualified heir who receives the property that is the subject of the election.

1.2.3.5. The benefit of any reduction in tax attributable to property qualifying for the marital or charitable deduction shall inure to the recipient of that property. Any increase in death taxes attributable to a disclaimer of such property or a failure to elect to qualify any part of a bequest that otherwise could constitute QTIP property under §2056(b)(7) of the Code shall be charged to the disclaimed or non-elected property without the benefit of any marital deduction otherwise available to my estate.

1.2.3.6. The benefit of any tax rate differential in computing death taxes attributable to the relation of the recipient to me shall inure to that beneficiary.

1.2.3.7. The benefit of any other entitlement directly attributable to identifiable property shall inure to the beneficiary who receives that property.

1.2.4. Temporal Interests: Death tax attributable to property held in temporal interests (e.g., a life estate, annuity, or term of years, followed by a remainder) shall be paid from corpus to the extent the effect thereof is to amortize the cost over the respective interests but otherwise shall be apportioned between the respective interests based on their respective values. Apportionment to a lead interest may entail a loan from principal or recomputation of an annuity or other guaranteed payment, but neither this paragraph nor any provision of state law shall apply to the extent the effect is to reduce a deduction otherwise allowable for any part of the property.

1.2.5. QTIP Property: Notwithstanding paragraph 1.2.3.5., with respect to property includible in my estate under §2044 of the Code, all taxes attributable to all §2044 property shall be determined on a pro rata rather than the incremental basis provided by §2207A and shall be apportioned to the §2044 property with the highest inclusion ratio to the extent doing so will not constitute a constructive addition with respect to any §2044 property with a lower inclusion ratio.

1.2.6. Exoneration: Notwithstanding any other provision of this will, the recipient of property described in this paragraph shall not be subject to apportionment and the taxes attributable to this property shall be paid by the remaining recipients of property includible in my estate according to the computation of attributable tax described in paragraphs 1.2.1. and 1.2.2.

1.2.6.1. To the extent apportionment of the attributable tax would violate federal law relating to employee benefits and deferred compensation.

1.2.6.2. To the extent apportionment of the attributable tax would cause an acceleration of income taxation or to the extent the property otherwise would be eligible for exclusion from my estate by §2039(c) or §2039(e) of the Code pursuant to the transition rules in §§525(b)(2) through 525(b)(4) of the Tax Reform Act of 1984 as amended.

1.2.6.3. Proceeds of life insurance that are exempt from inheritance or similar death taxes to the extent not subject to apportionment because paid to a beneficiary other than my personal representative.

1.2.6.4. Property not passing under this will to the extent the total tax attributable thereto is less than *% of the total death taxes described in paragraph 1.1.

1.2.6.5. Property passing under * of this will (relating to personal property) to the extent the total tax attributable thereto is less than *% of the total death taxes described in paragraph 1.1.

1.3 Reimbursement: Because it is my intent to apportion death taxes as described above, it is unnecessary to assert the rights to reimbursement provided by §§2206, 2207, 2207A, 2207B, and 2603 of the Code (and any similar provisions hereafter adopted) and, except to the extent inconsistent with the foregoing, I hereby waive those entitlements.

1.4. Interest and Set Offs: In the discretion of my personal representative death taxes attributable to property not passing under this will may be paid out of the residue of my estate prior to recovering the attributable tax from the recipient of that property.

1.4.1. Attributable tax that has not been paid by the recipient before my personal representative pays death taxes or that is not yet due because my personal representative made a valid deferral election under §6161, §6163, or §6166 of the Code shall bear interest equal to that imposed by the Code on my personal representative.

1.4.2. In the discretion of either my personal representative or a beneficiary under this will, as a form of payment by that beneficiary to my personal representative, any entitlement of that beneficiary under this will may be applied in payment of that beneficiary's share of the taxes and interest attributable to other property received by that beneficiary.

1.4.3. In its discretion my personal representative may distribute my estate in whole or in part prior to final audit and settlement of the tax liability of my estate, notwithstanding that attributable taxes may be altered thereafter.

1.4.4. My personal representative shall not be personally liable for withholding an insufficient amount as a set off against the liability of a recipient or for failing to recover attributable taxes or interest following reasonable efforts and shall not be required to litigate to enforce apportionment unless indemnified against the costs thereof.

1.5 Adjustments: My personal representative's selection of assets to be sold to pay death taxes, and the tax effects thereof, shall not be subject to question by any beneficiary. My personal representative is hereby indemnified against any liability it may incur to any recipient of property not passing under this will for the effect of any action taken in the computation or payment of death taxes that directly or indirectly affects any recipient's liability under this provision. Elections or allocations authorized under the Code may be made by my personal representative in its discretion without regard to or liability for the effect thereof on any beneficiary or any tax consequence thereof. No adjustment shall be made between income and principal, in the relative interests of the recipients, or in the amount or selection of assets allocated to any trust under this will to compensate for the effect on any such action or for the effect on the amount of any tax attributable to any recipient of property includible in my estate for death tax purposes.

1.6 Conflict of Laws: For all purposes of interpreting this provision and ascertaining the rights of any recipient of property includible in my estate for death tax purposes the law of the state of my domicile at death shall govern notwithstanding the nature or location of the property or the domicile of the recipient.

CAUTION

The foregoing form is drafted for use in a will. If adapted to be used in a trust, remember also to include a provision in the client's will waiving all rights of reimbursement (see paragraph 1.3) because only a will may waive the rights granted by §§2206 and 2207.

If multiple documents will be used for the estate plan, be certain that all tax clauses mesh in terms of calling for payment in a consistent manner and all from the proper sources in the same order or under the same conditions. A provision in a trust authorizing a loan to or purchase of assets from the settlor's estate may be as effective as a separate tax payment directive in the trust, especially if the trust corpus otherwise is not includible in the settlor's estate at death.

For those faint of heart who fear that paragraph 1.2 is not adequate, the following paragraph appropriately might be appended to make even more clear the drafter's intent.

1.7 Construction: To the extent a provision relating to the payment or apportionment of taxes is unclear or no provision addresses a particular issue, the overriding principle to be applied is full apportionment of tax liabilities to those dispositions generating the tax, reflecting the notion of equitable apportionment to the fullest possible extent to minimize taxes by preserving deductions, exclusions, and exemptions.

THE FOREGOING FORMS ARE NOT WARRANTED AS SUITABLE FOR ANY GENERAL OR SPECIFIC USE. THE USER IS RESPONSIBLE FOR DETERMINING HOW THEY SHOULD BE ADAPTED TO ANY PARTICULAR SITUATION.

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Revised Uniform Estate Tax Apportionment Act Appendix

Coming to a legislature near you! The National Commissioners on Uniform State Laws gave its final reading to the Revised Uniform Estate Tax Apportionment Act in August 2003. Drafted to freshen up the current (1969) version of the Act, a number of changes are made that improve the Uniform Act, but a variety of issues remain unresolved and decisions were made that may differ from what your clients may prefer. As a result, be careful about whether to default into state law in your state or any other: it is very likely that a well drafted tax payment provision will produce better results than any version of state law, including the new revised Uniform Act.

The new revision is totally rewritten but bears many resemblances to the old. For comparison purposes the drafters provided a document that identifies the major substantive changes made from the current Act. Consult the Univ. of Pennsylvania website for these materials, and this document specifically at www.law.upenn.edu/bll/ulc/uetaa/newfeb2003comparison.html. The drafters listed seven notable alterations found in the new Act:

1. It adds apportionment of foreign death taxes and generation-skipping transfer tax on a direct skip occurring at the decedent's death.

2. It alters the mechanism for allocation of taxes by eliminating from the denominator of the fraction for pro ration (a) any deductible claims and expenses against the estate (regardless of whether they are deducted) and (b) any §2035(b) gross-up tax amount. In each case the effect is to increase the tax apportioned to every person to whom tax is apportioned in the estate.

3. It expands the prior rule to permit a decedent to override the statutory regime by a provision in a revocable trust or other dispositive instrument, rather than just by a will.

4. It creates a complex approach for apportionment of tax to temporal or other "insulated" property (meaning dispositions such that access to liquid funds is impossible or impracticable). Tax attributable to such dispositions is paid from other "uninsulated" property and those payments constitute "advancements" that give the beneficiaries who incur the tax a future right to reimbursement from the takers of insulated property, delayed until a subsequent distribution of an insulated disposition occurs. Effected through a fractional reimbursement entitlement that is illustrated in the comments to §6 of the new Uniform Act, observers will do well to carefully evaluate the complexity of the approach adopted.

5. It allocates the benefit of the §§2012 and 2014 gift tax and foreign death tax credits.

6. It allocates the benefits generated under §2057 (the deduction for qualified family owned business interests), §2032A (special use valuation), and § 2031(c) (conservation easements).

7. It identifies the costs to defer tax under §§6161, 6163, and 6166 and apportions interest and penalties attributable to them.

The new Act does not make a number of other important changes, likely for a variety of reasons. Reviewers may want to consider whether to recommend to their legislature that its consideration of the new Act be accompanied by a study of additions that might improve the Act. For example, it would be desirable if state law addressed questions such as:

a. Apportionment of the estate tax generated by §2035(b) gross up rule inclusion of gift tax paid within three years of death. Should the donee of the gift that generated the gift tax that was paid by the donor incur the added estate tax attributable to the gross up rule, or should the legislature assume (as did the drafters) that the donor who paid the gift tax intended that the donee take free and clear of *all* tax, including any unanticipated estate tax attributable to the gift tax payment? This is a very hard issue, on which a colloquy on the topic appears below to indicate how the drafters considered issues of this nature, making it easier to see how or why a state legislature might deviate from the new Uniform Act, or add to it.

b. There are a number of interesting equitable apportionment or adjustment issues not anticipated by the new Uniform Act. One illuminating example is the §691(c) income tax deduction for estate tax attributable to Income in Respect of a Decedent (IRD). Who should benefit from that income tax deduction: the beneficiary against whom the estate tax was apportioned that generated the income tax deduction, or whomever is the income beneficiary whose income tax is reduced? Another illustration is the §2058 state death tax deduction: it is not so clear how §2(1)(B) of the new Uniform Act is meant to operate when it refers to "the value of any interest in property that . . . qualifies for the marital or charitable deduction *or otherwise is deductible or exempt*" in this context; does that provision accomplish the equitable apportionment result that should apply for those who pay state death tax that generates the §2058 deduction? A third example is the apparent failure to apportion differences in state inheritance or other death tax rates that vary based on the relation of the beneficiary to the decedent.

c. The new Uniform Act does not apportion the benefit of a number of credits more important than §§2012 and 2014, most significantly the §2013 previously taxed property credit. The drafting issue is whether the person who incurred the estate tax that generates the credit should get the benefit of that credit. By default the Act allocates the §§2010 unified credit and 2058 state death tax deduction to all beneficiaries of the estate and potentially either or both benefits also should be allocated more directly to one class of beneficiaries or another (such as the §2058 deduction benefiting the takers of property that incurred and paid the state death tax in question).

d. The new Uniform Act also addresses recapture taxes in an oblique manner but fails to consider all the different forms of recapture tax that may impact a decedent's estate. One obvious and likely to be common illustration is the §529(c)(4)(C) recapture of accelerated annual exclusion made available to contributors to college education plans.

e. The new Uniform Act continues the basic paradigm that taxes attributable to property that is broken into temporal interests (such as a life estate or annuity, and remainder) shall be paid from corpus. The mechanism embraced is complex and most especially produces untoward results in cases in which a lead annuity of a fixed dollar amount is involved. The state law issue is whether an adjustment provision could be formulated that would be more fair and easier to employ.

f. Waiver by a will, trust, or other dispositive document requires an "express" or "unambiguous" provision (see §3) but the comment to that rule refers to "explicit" and "specific" references. Federal law §§2207A and 2207B require the decedent to "specifically indicate an intent" to alter their entitlements. It might be wise for state law to mimic federal law so that standards adopted for each will inform the others.

g. The provisions that consider the generation-skipping transfer taxes could be more refined. For example, any tax on a direct skip that occurs at death is addressed by the Act as if direct skip tax always is something the decedent could have anticipated. In that regard direct skip generation-skipping tax caused by a child's disclaimer often is excluded from well drafted tax payment provisions because it is thought that the child's trust normally would incur the generation-skipping tax (usually when the child dies) and the child's disclaimer should not accelerate that tax *and* change the source for its payment. Direct skip tax incurred on a disclaimer by a skip person is another story, because that direct skip tax presumably was anticipated by the decedent. Moreover, apportionment of estate tax to a QTIP marital trust includible in the decedent's gross estate under §2044, either under the §2207A reimbursement right or a comparable state law, appropriately might be allocated first against property with an inclusion ratio of one rather than against exempt property attributable to a reverse QTIP election with an inclusion ratio of less than one. The Uniform Act does not does protect the exemption by invading the nonexempt property first.

h. The new Uniform Act does not appear to apportion fees and expenses that are incurred by a probate estate in its compliance with the tax law but that are attributable to nonprobate assets. For example, a large valuation expense might be incurred with respect to nonprobate assets includible in an estate but directly expensed to the personal representative who is filing the estate tax return. Shouldn't those nonprobate assets pay for that expense? Nothing in most state laws or in the new Uniform Act makes such an allocation.

i. Finally, state law might legislatively address the conflict of laws issue that regularly will arise with respect to decedents with property located in multiple jurisdictions, potentially subject to the state apportionment rules of several.

Now, here is that colloquy between an observer/commentator (**O**) regarding the Act in an earlier draft, and a member of the drafting committee advisory board (**A**). It shows a number of ways that others in the legislative process might view their role and the standards to be applied by the legislature in making certain determinations regarding apportionment:

> **O**: I agree [with a letter written by yet another commentator] that the estate tax attributable to the gross up rule of §2035(b) ought to be allocated to the donee of the gift.
>
> **A**: There was probably no doubt that donors of inter vivos gifts intended them to be free of tax. This is not an issue of conceptual purity, but of almost certain intent.

O: I would bet that no donor ever considered the §2035(b) gross up tax (unless some advisor put the question to them). I grant that donors almost without exception (that exception being a net gift, in which intent is quite clearly expressed) want their donees to take free of GIFT tax, but this IS different. It is a tax that I would guess the donor never intended or contemplated. And if the transfer were at death — which is what §2035(b) is equating — the statute y'all are drafting assumes that the donor would want the donee to pay the tax on the transfer — your paradigm is full apportionment. So I question whether this is as clear a case of presumed intent as you represent.

A: We started out with the proposition that preresiduary legacies would be exempt from apportionment, on the theory that probable intent justified this. The inter vivos gift is an a fortiori case. The preresiduary result was changed because of disputes on limitations on exemptions and the interplay between reapportionment and the marital and charitable deductions; that, however, shouldn't get in the way of the clearer case.

O: Imagine a situation involving an inter vivos gift, not to spouse or charity, that produces gift tax paid within three years of death. The estate at death goes entirely to charity or surviving spouse and would be nontaxable due to those charitable and marital deductions. But you have estate tax attributable to the gross up rule. Is it really the intent of the drafting committee that the deductions at death — that everyone thought would make the estate tax free — would be reduced because tax attributable to the inter vivos gifts would be paid from the estate in general? Your result will start a whirlpool calculation that would produce a relatively large and entirely unexpected tax liability at death. And, I suspect, not the intent of the decedent or the drafter at all.

Every time I confront a tax apportionment issue, the only results that seem to work when you play them out to the end are full apportionment — everyone pays their own way. The only quibble here is what that means, and I think still it is clear that if the donor wants to exempt someone from a tax liability it is best if the donor specifically identifies the gift or the person and says "don't make that person pay" — but otherwise any tax attributable to a transfer to that person comes from that person. Here you have what I think we can agree would be an "unanticipated" tax liability and the only way I know that will avoid second and third level problems is to say, sorry, the donee pays. Even if the donor paid the gift tax on the original gift, if the planner and the donor failed to anticipate and plan specifically for the gross up tax, I think having the donee pay is the right and less likely destructive result.

After all, isn't your statute meant to provide rules for when people failed to think these issues through and draft an efficient and different result? I truly believe that when you pursue these kinds of questions the initial notion of what someone would intend (donee gets the gift, tax free, for example) nearly always proves to be too blunt or simplistic or could not anticipate the kinds of events that unfold and produce the kinds of litigation that we encounter.

A: I am not troubled by exoneration of preresiduary gifts even if the residuary is nontaxable. In fact, that is what most, if not all, wills I have seen provide. On that basis I feel very comfortable that we have captured probable intent. It is also considerably simpler in cases where the donee is not a beneficiary at death.

O: I suspect most of the burden on the residue logic of most drafters is a function of ease of administration. But I also think that most of the disasters that occur are a function of burden on the residue. I'm not smart enough to know where to draw the line between trying to avert disaster and facilitate administration, and I don't have any experience in knowing what most people intend — especially the vast majority of those who never thought to form an intent!

The hard issue to my mind is whether such a statute should try to predict intent or avert disaster. I'm of a mind that intent is easy enough to draft affirmatively, so state law should do what so many UPC provisions have — which is to anticipate problems and prevent them from becoming disasters.

As the colloquy shows, the objective of the drafters of the new Uniform Act may differ from what your legislature has in mind to accomplish with laws in this area. It will be important to consider first how the legislature wishes to approach its task (what the objective of the legislation should be) and then to consider the types of rules or decisions that should be embraced under that policy. Whatever the result, wise estate planners will realize that state law probably does not do everything that a well crafted tax apportionment provision should accomplish, and likely will create their own set of provisions either to override or to supplement state law. Given the variety of state laws that may apply and the diversity of client investments and their locations, it seems likely also that a drafter will not be able to rely on the application of just one state's rules.

The following smattering of recent decisions is notable in that they have a common thread. See if you detect the common mistake that seems to inform these, and the vast majority of these unfortunate cases.

***In re* Estate of Klarner**, 98 P.3d 892 (Colo. Ct. App. 2003), cert. granted, involved two interesting issues in the context of a qualified terminable interest property (QTIP) trust created by a deceased husband for his surviving wife. One was the court's rejection of administration expense apportionment to the QTIP trust without authority to do so under state law. There is very limited authority for such an apportionment and the court reached the traditional result (although not necessarily the equitable one). The other issue was estate tax apportionment against the QTIP trust, the court concluding that the specificity required by §2207A relating to waiver of the right of reimbursement for federal estate tax had no counterpart with respect to the *state* death tax burden. The net result was that the surviving wife's estate plan, which contained a burden on the residue tax payment direction, was regarded as adequate to reject state law apportionment of the state death tax burden to the QTIP trust and instead placed it on the residue of the surviving wife's estate. This caused the QTIP trust to benefit the children of the settlor (the first spouse to die), at the expense of the children of the surviving spouse. That is not a result normally expected, and it highlights the need to consider both state and federal law in drafting tax apportionment provisions.

Hollis v. Forrester, 2004 Ala. Civ. App. LEXIS 823, involved a different convolution to produce different claimants to the estate of the surviving spouse (heirs at law) and of the QTIP trust (nieces of the settlor), and state law differed as well (Alabama is one of only four states still retaining the burden on the residue rule), but the net result was the same: state estate tax in the surviving spouse's estate, attributable to inclusion of a QTIP marital deduction trust, were a charge against the survivor's residuary estate and were not payable in the same manner as the federal estate tax from the QTIP trust. People will fight over this and the only difference in *Hollis* from *Klarner* is that the surviving spouse had no tax payment provision, instead of having an ineffective one. Otherwise, would anyone doubt that the result reached in either case was contrary to the intent of the surviving spouse? Or that one more case is likely (involving an estate planner's malpractice liability)?

***In re* Estate of Siebrasse**, 678 N.W.2d 822 (S.D. 2004), may have reached the "right" state law result, and it may have been the testator's intent as well, but it showcased an issue that might be addressed in more tax payment provisions. The simple situation was division of an estate that resulted in one brother receiving realty that he thought was overvalued for federal estate tax purposes, and he proved it. In the end this beneficiary generated a refund of federal estate tax, which this beneficiary thought should belong entirely to him. The state supreme court reversed a lower court that agreed with him, noting that under state law and the terms of the document equal division of the estate after payment of all taxes meant that every beneficiary shared pro rata the tax liability as finally determined. In tax payment planning, however, quaere whether benefits that are beneficiary specific (such as §2032A special use valuation that requires the beneficiary's material participation) ought to be allocated to the particular recipient who generates that benefit. *Siebrasse* confirms that state laws typically do not apportion those benefits without a specific direction in the document.

Estate of Green v. Commissioner, 86 T.C.M. (CCH) 758 (2003), involved generation-skipping transfer tax on a direct skip bequest and held that the decedent intended to exonerate direct skip bequests from paying the generation-skipping tax. At the same time, however, the plan did not effectively exonerate the same bequests from state or federal *estate* tax. The net result was that the generation-skipping tax was imposed on the other residuary beneficiary of the estate, which was a charity. That caused a reduction in the federal estate tax charitable deduction, which generated federal estate tax, an equal share of which *was* imposed on the direct skip beneficiaries under state law equitable apportionment. The net result was that more wealth passed to the direct skip beneficiaries than if §2603(b) had applied to apportion all the generation-skipping transfer tax against the direct skip bequest, but it is doubtful that the result was what anyone anticipated when drafting the decedent's estate plan.

In **Estate of Lurie v. Commissioner**, 87 T.C.M. (CCH) 830 (2004), the decedent exhausted the unified credit on inter vivos transfers, meaning that no credit shelter trust was created under the estate plan. The estate plan included a tax payment provision in a pour over trust that was directed to pay if the probate estate was insufficient, which was the case. Indeed, by stipulation, it was agreed that trusts created for the decedent by a third party were includible in the estate, to the tune of over $40 million. State law provided that, in the absence of a contrary direction in the decedent's estate plan, tax generated by nonprobate assets would be paid from those assets under the concept of apportionment, here both outside and equitable apportionment (because the estate otherwise would pass entirely to the surviving spouse and qualify for the marital deduction, generating none of the estate tax). Because state law was deemed waived by the tax payment provision the net result was a reduction of the marital deduction by the taxes paid on the $40 million, resulting in a final estate tax of over $47 million (after reduction of the marital deduction to pay the tax on the $40 million, and then payment of estate tax because of loss of the marital deduction, and further payment of that tax and another round of lost marital deduction, with yet more estate tax, all in a circular whirlpool calculation).

***In re* Estate of Williams**, 2003 Tenn. App. LEXIS 313, raised that age-old nonprobate property issue whether divorce revokes a beneficiary designation in favor of a now former spouse. The court held not, and the decedent drowned 54 days after the divorce, without having changed the beneficiary designation, meaning that the former spouse received annuities that were includible in the estate, with no matching marital deduction, State law again dictated equitable apportionment but the tax clause in the decedent's estate plan directed payment of all taxes from the residue of the estate and waived all rights of reimbursement. The court found that state law was made inapplicable by that direction and rejected the estate's argument that the tax clause should be ignored because it benefited the former spouse and all provisions in a will that benefit a former spouse are regarded by state law as revoked upon divorce (state law actually stated that "divorce revokes any disposition . . . to the former spouse" and the tax payment provision was not such a "disposition" to the spouse).

***In re* Estate of Overturf**, 819 N.E.2d 324 (Ill. Ct. App. 2004), raised an issue that should have been addressed in the estate plan because it is anyone's guess how the decedent would have addressed the inequity that arose. The residuary estate was divided equally between two daughters but one daughter survived to a larger share of joint tenancy property owned by the decedent with the respective daughters. The estate tax burden was placed on only the personal property in the residuary estate, which proved to be inadequate. The daughter who was disfavored in the joint tenancy property argued that the unfulfilled tax liability should be charged under state law outside apportionment proportionately to the two daughters, each paying different amounts relative to the amounts of joint tenancy property each received. The favored daughter argued that state law imposed the excess tax liability against the realty included in the residuary estate, which equally burdened both daughters. The court imposed equal amounts of the tax against the two daughters notwithstanding disparate division of the decedent's aggregate wealth, finding that the tax payment provision looking solely to probate personalty failed and therefore that state law apportionment against the remaining probate estate would prevail. Had the probate personalty been adequate that inequity would have been the end result, so the conclusion is consistent with the plan as drafted, but was the resulting inequity understood and intended by the decedent? A statement confirming that intent might have avoided the litigation.

Finally, **Rosen v. Wells Fargo Bank Texas**, 114 S.W.3d 145 (Ct. App. Tex. 2003), was one ray of good news for taxpayers, holding that equitable apportionment *would* apply to protect a bequest to the decedent's surviving spouse, but only because the testamentary direction to pay all transfer taxes "out of the residue of my estate without apportionment" failed when the residue of the estate was exhausted. This caused taxes to be paid from nonprobate assets includible in the estate, pursuant to state law that applied once the tax payment provision cratered. That fortunate result was the product of effective postmortem lawyering and the fortuitous selection of a preresiduary marital bequest that was protected against abatement or tax payment when the residuary tax payment direction proved ineffective to override state law. "The lack of a residuary estate negates any specific direction for apportionment and therefore the default apportionment provisions of [state law] should apply."

Now the question with which we began: What mistake in drafting generated the litigation in all eight cases? A tax payment provision directing payment of taxes from the residue of the estate, waiving all rights of apportionment or reimbursement. A so-called "dad buys dinner" tax payment provision. Nothing produces more litigation in situations involving unanticipated assets or developments.

KENTUCKY PRENUPTIAL AGREEMENTS:

GENERAL SURVEY, DRAFTING, AND LITIGATION

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SECTION H

KENTUCKY PRENUPTIAL AGREEMENTS: GENERAL SURVEY, DRAFTING, AND LITIGATION

I. Introduction and Scope

With the increase in blended families, wealth of the baby-boomer generation, and the current divorce rate, protection of assets with regard to marital rights is increasingly relevant for attorneys who practice in the area of estate planning and family law. This article sets forth the general principals of Kentucky law applicable to prenuptial agreements, drafting guidelines utilizing lessons from Kentucky case analysis, and a brief discussion of relevant issues of premarital agreement litigation.

A prenuptial agreement (also known as an antenuptial agreement) is an agreement entered into by prospective spouses prior to marriage but in contemplation and in consideration thereof. [1] Prenuptial agreements are favored under Kentucky law.[2] In fact, the overwhelming majority of prenuptial agreements litigated in Kentucky are upheld.[3] Only in very rare instances have prenuptial agreements been struck down in their entirety by Kentucky Courts.

II. Kentucky Prenuptial Agreements: General Requirements for a Valid Prenuptial Agreement

Kentucky law recognizes the validity of prenuptial agreements for the disposition of property in the event of death or a divorce.[4] However, to be enforceable, a prenuptial agreement must be supported by valid consideration, even if such consideration is only the marriage itself.[5] Further, to be enforceable, prenuptial agreements must be in writing.[6]

In addition to the above requirements, in 1990, the Kentucky Supreme Court ruled that the enforcement of prenuptial agreements is subject to three limitations:[7]

(1) Was the agreement obtained through fraud, duress, or mistake, or through misrepresentation or nondisclosure of material facts? (*Gentry* Element 1);
(2) Is the agreement unconscionable? (*Gentry* Element 2); and
(3) Have the facts and circumstances changed since the agreement was executed so as to make its enforcement unfair and unreasonable? (*Gentry* Element 3)

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[1] Blacks Law Dictionary
[2] Hardesty v. Hardesty's Ex'r, 34 S.W.2d 442 (Ky. App. 1931)
[3] See Appendix A Summary of Prenuptial Agreement Cases
[4] Stratton v. Wilson, 185 S.W. 522 (Ky. App. 1916); Gentry v. Gentry, 798 S.W.2d 928 (Ky. 1990) and Edwardson v. Edwardson, 798 S.W.2d 941 (Ky. 1990)
[5] Luck v. Luck, 711 S.W.2d 860 (Ky. App. 1986)
[6] KRS 371.010(5)
[7] Gentry v. Gentry, 798 S.W.2d 928 (Ky. 1990)

These Ge*ntry* limitations apply to prenuptial agreements whether in the context of death or divorce.

III. Examination of *Gentry* Limitations on Prenuptial Agreements

A. Was the agreement obtained through fraud, duress, or mistake, or through misrepresentation or nondisclosure of material facts?

(1) Fraud

A prenuptial agreement is often a vehicle for the protection of assets in the event one prospective spouse has assets which are significantly greater than the other prospective spouse. An argument may be attempted that the spouse seeking to protect assets may have been fraudulent simply by virtue of the amount of assets that he or she may have in comparison to his or her spouse's assets. However, disparity of assets alone without other supporting circumstances does not in itself constitute fraud.[8]

The court may consider parol evidence to determine whether proper disclosure was made when fraud is alleged.[9] For example, in *Lipski v. Lipski*, the Court considered evidence that the wife discussed the prenuptial agreement and its terms with family members in determining whether her knowledge satisfied the disclosure element.[10] The court upheld the agreement.[11]

(2) Disclosure of Assets

To be bound by a premarital agreement, each spouse must have been apprised of the nature and extent of his or her prospective spouse's estate and the value of the marital rights which he or she is surrendering.[12] Courts have not commented on just how detailed this disclosure must be, only noting that to be valid, a prenuptial agreement must include an accurate listing of the assets it purports to cover.[13]

For the purpose of protecting assets, an attorney should assume that more detail provides greater protection of the asset. Consider, the Court of Appeals analysis in *Lane v. Lane* where the wife contested a general

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8 Harlin v. Harlin, 87 S.W.2d 937 (Ky. App. 1935); also see Brown v. Brown, 265 S.W.2d 484 (Ky. App. 1954)

9 Gaines v. Gaines' Adm'r, 173 S.W. 774 (Ky. App. 1915)

10 Lipski v. Lipski, 510 S.W.2d 6 (Ky. App. 1974)

11 Id.

12 Potter's Ex'r v. Potter, 29 S.W.2d 15 (Ky. App. 1930); Lawson v. Loid, 896 S.W.2d 1 (Ky. 1995)

13 Luck v. Luck, 711 S.W 2d 860 (Ky. App. 1986); also see Lane v. Lane, 2004 WL 178374 (Ky. App. 2004)

reference in the prenuptial agreement to "pension plan" as not including the husband's 401(k).[14] The Court considered the specific facts of the case and ultimately found that the reference to "pension plan" did refer to and include the husband's 401(k).[15] A clear designation to the 401(k) account with corresponding account number may have avoided this issue altogether.

In one of the few cases where a prenuptial agreement was struck down in Kentucky, the Kentucky Court of Appeals took into consideration the lack of disclosure of assets to the prospective wife prior to the execution of the purported prenuptial agreement.[16] However, other factors that contributed to the failure of that prenuptial agreement included execution of the document on the day of the wedding and the fact that counsel advised neither party. [17] In a similar case, the Kentucky Court of Appeals Court struck down a prenuptial agreement where the prospective wife had limited reading ability, was not read the proposed agreement, and signed the document the day of the wedding. [18]

When challenged, the burden of proof regarding the questions of full disclosure of assets at the time of the prenuptial agreement was entered into rests on the party relying on the prenuptial agreement.[19]

(3) Sophistication of the Parties

The sophistication of the parties is relevant to the enforcement of a prenuptial agreement. The Kentucky Supreme Court has reviewed the issue of disclosure and upheld a prenuptial agreement noting that factors such as the age, education, previous marriages, and work experience are relevant to whether the burden of disclosure has been satisfied.[20] In addition, other cases have considered the education and judgment of a spouse to be a relevant factor in determining the viability of a prenuptial agreement. [21]

B. Was the prenuptial agreement is unconscionable?

Courts will review a prenuptial agreement at the time of the termination of the marriage.[22] This is so whether the termination of the marriage is a result of either death or by divorce. Courts are possessed of this power:

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14 Lane v. Lane, 2004 WL 178374 (Ky. App. 2004)
15 Id at 4
16 Luck v. Luck, 711 S.W.2d 860 (Ky. App. 1986)
17 Id.
18 Potter's Ev'r v. Potter, 29 S.W. 2d 15 (Ky. App. 1930)
19 Harlin v. Harlin, 87 S.W.2d 937 (Ky. App. 1935)
20 Lawson v. Loid, 896 S.W.2d 1 (Ky. 1995)
21 Lipski v. Lipski, 510 S.W.2d 6 (Ky. App. 1974)
22 Gentry v. Gentry, 798 S.W.2d 928 (Ky. 1990); also see Blue v. Blue, 60 S.W. 3d 585 (Ky App. 2001)

> to ensure that facts and circumstances have not changed since the agreement was executed to such an extent as to render its enforcement unconscionable.[23]

A prenuptial agreement is "unconscionable" and must be set aside if the court determines that it is "manifestly unfair and unreasonable." [24]

The difficulty of this definition is that the consequences seem to be subjective to the particular court and the parties to the action. A lawyer must carefully explain *Gentry* Element 2 to his to his or her client prior to execution of the agreement. In essence, what the lawyer must convey is that even under a perfect situation where all aspects of a prenuptial agreement should render the agreement enforceable, the Court will review the agreement for validity and consider the circumstances of the parties at the time of enforcement (be it 1 year or 50 years) to determine whether the agreement is "manifestly unfair or unreasonable." Although daunting, again consider that the overwhelming majority of prenuptial agreements in unreported cases in Kentucky are in fact upheld when challenged. [25]

C. Have the facts and circumstances changed since the agreement was executed so as to make its enforcement unfair and unreasonable?

There is not a specific discussion by Kentucky Courts concerning what type of "change in circumstances at the time enforcement is sought" will render an agreement unconscionable. Rather, the fairness of the premarital agreement will be considered on a case by case basis.[26]

There are two recent cases that may provide some guidance in examination of the *Gentry* Element 3. In *Blue v. Blue*, the wife argued that the significant increase in Mr. Blue's wealth during marriage rendered the enforcement of the agreement unconscionable, unfair and unreasonable.[27] In *Blue* the Kentucky Court of Appeals upheld the prenuptial agreement and applied a Substantive Fairness Test, the Court found:

> A more appropriate test of the substantive fairness of a prenuptial agreement requires a finding that the circumstances of the parties at the time the marriage is dissolved are not so beyond the contemplation of the parties at the time the

[23] Gentry v. Gentry, 798 S.W.2d 928 (Ky. 1990); also see Blue v. Blue, 60 S.W. 3d 585 (Ky App. 2001)
[24] Shraberg v. Shraberg, 939 S.W.2d 330, 333 (Ky. 1997)
[25] See Appendix – Summary of Kentucky Prenuptial Agreement Cases
[26] Edwardson v. Edwardson, 798 S.W.2d 941 (Ky. 1990)
[27] Blue v. Blue, 60 S.W.3d 585 (Ky. App. 2001)

prenuptial agreement was entered into as to cause its enforcement to work an injustice.[28]

Ms. Blue's contention was that her spouse's increase in net worth from an estimated $5,000,000 at the time the prenuptial agreement was entered into to an estimated $77,000,000 at the time of termination of the marriage rendered the enforcement in violation of *Gentry* Element 3. The Court upheld the Blue prenuptial agreement finding that the mere increase in Mr. Blue's nonmarital assets does not render a prenuptial agreement unconscionable. Other factors that the Court seemed to consider as relevant: Mrs. Blue received in excess of $650,000 pursuant to the prenuptial agreement; each party was represented by counsel; and each party had been previously married.

Interestingly, Mr. and Mrs. Blue (soon known as Mr. Blue and Ms. Ford) took yet another trip to the Kentucky Court of Appeal relative to their prenuptial agreement dispute.[29] See Attorney Fees below in Section V of this Article.

In a recent decision by the Kentucky Court of Appeals the Substantive Fairness Test was applied to uphold a prenuptial agreement and deny maintenance to a non-college educated wife.[30] The Court indicated that the wife failed to meet her burden of showing that she did not contemplate the significant increase in the annual income of her college educated husband.[31] The Court reviewed Mr. Lane's earning capacity throughout the marriage which was approximately $166,000 at the time of the marriage and approximately $1,000,000 before termination of the marriage.[32] The Court concluded that Mr. Lane's career was developing during the marriage, a fact which in light of his educational background should have been recognized by the parties. In addition, as in the 2001 *Blue* decision, the *Lane* Court in this case also seemed to take into consideration the amount of property that Ms. Lane received (approximately $300,000 of marital and non-marital funds).

IV. Maintenance

A prenuptial agreement can determine maintenance/alimony so long as there has been full disclosure and subject to scrutiny for unconscionability.[33]

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[28] Id.
[29] See Ford v. Blue, 106 S.W.3d 470 (Ky. App. 2003)
[30] Lane v. Lane, 2004 WL 178374 (Ky. App. 2004)
[31] Id.
[32] Id.
[33] Edwardson v. Edwardson, 798 S.W.2d 941 (Ky. 1990)

V. Attorney's Fees

While few prenuptial agreements have been struck down in their entirety, prenuptial clauses concerning payment of attorney fees are often disregarded by courts when there is a disparity in assets between the parties.[34] This is so, even if the agreement is otherwise found to meet the three Gentry requirements.[35]

VI. Defenses to Prenuptial Agreement

As the vast majority of challenged prenuptial agreements since 1891 have been upheld, very little law exists as to recognized defenses. However, a few remain. For example, abandonment is a recognized defense to the enforcement of a prenuptial agreement in Kentucky.[36]

In addition, destruction of original premarital agreement coupled with intent to revoke can invalidate a prenuptial agreement.[37] Although a recognized case does not exist, it could be argued that a missing original without a photocopy is evidence of revocation of the agreement. This would be similar to cases that have examined this scenario in the context of a last will and testament.

VII. Limitations on Prenuptial Agreements in Kentucky

Questions of child support, child custody, and visitation are not subject to a premarital agreement.[38]

VIII. Drafting Prenuptial Agreements

A. Preparation Necessary for Drafting a Prenuptial Agreement

(1) Representation

The general rule is that a lawyer shall not represent a client if the representation of that client will be directly adverse to another client.[39] The interests of parties entering into a contractual agreement to define (and most likely restrict) their marital rights are obviously adverse. Therefore, when an attorney is contacted by a potential client concerning a prenuptial agreement, the attorney should consider representing the interests of only one soon-to-be spouse. The other soon-to-be spouse may be best served be represented by counsel of his or her own choosing.

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[34] Ford v. Blue, 106 S.W.3d 470 (Ky. App. 2003); Lane v. Lane, 2004 WL 178374 (Ky. App. 2004)
[35] Also see Appendix A, Summary of Kentucky Prenuptial Agreement Cases
[36] Prather v. Cox, 689 S.W.2d 623 (Ky. App. 1985)
[37] Carter v. Carter, 656 S.W.2d 257 (Ky. App. 1983)
[38] Edwardson v. Edwardson, 798 S.W.2d 941 (Ky. 1990)
[39] See SCR 3.130(1.7)

Fee agreements should be written and should detail the method of compensation to the lawyer whether a flat fee or an hourly based rate. Generally, the attorney preparing the prenuptial agreement may want to be engaged at an hourly rate as negotiation with opposing counsel and education of the client may be difficult to gauge and may depend upon the specific situation of the client.

(2) Client Information

Once a written fee agreement is in place and each party is represented by separate counsel, the attorney should require his or her client to complete a written information sheet. The information sheet should be comprehensive as to the client's assets and liabilities. Supporting documentation should be attached including account statements, copies of deeds, copies of close corporation stock certificates, and retirement statements. Further, the lawyer should know his or her client's personal information including legal name, address, names and dates of birth of children, support obligations (maintenance, property settlement agreement with previous spouse, and child support), education, marital history, employment information (including annual income), and information concerning ownership interests in businesses.

The above described type of information is consistently taken into consideration by a court reviewing the agreement at enforcement time. Although generally it is the entirety of the circumstances that the court considers, it is relevant that the majority of recent cases detail the personal history of the spouses (previous married, education, etc.).

(3) Asset Disclosure

The completed information sheet serves the dual purpose of information gathering and recordkeeping for the attorney. In the event that the prenuptial agreement is challenged on the basis of inadequate disclosure, the attorney representing the alleged non-disclosing spouse may be called upon to justify his or her method of accounting for assets. Note that full disclosure is the basis for many prenuptial agreement challenges under Kentucky law. [40] Also, see Legal Malpractice in IX of this Article.

(4) Initial Client Meeting

Prior to the initial meeting, the attorney should have reviewed the completed asset sheet. The client needs to be advised and comprehend several difficult concepts and realities.

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[40] Lawson v. Loid, 896 S.W.2d 1 (Ky. 1995); Luck v. Luck, 711 S.W.2d 860 (Ky. App. 1986)

(a) The purpose of a prenuptial agreement.

The purpose is generally to define the marital rights of the parties prior to marriage and in the event of divorce or death. In addition, the lawyer should know the client's expectations concerning the scope of marital rights provided for in the prenuptial agreement.

(b) General summary of Kentucky law on prenuptial agreements

A key aspect is the client's understanding that a prenuptial agreement is not a guarantee against litigation. However, if certain requirements are met, the likelihood of a successful challenge is relatively small. The fundamental requirements to be complied with are:

1) Full disclosure of assets
2) Independent legal counsel
3) Adequate time prior to marriage to negotiate, prepare, and execute the agreement
4) A fair and reasonable agreement in light of the particular facts and circumstances of the parties
5) Client acceptance that the prenuptial agreements may be reviewed at the time of enforcement;
6) Prenuptial agreements may not define the scope of child support, child custody, and visitation are not subject to prenuptial agreements[41]

(5) After the Initial Meeting

The lawyer should draft a follow-up letter which serves as a review and summary of the meeting. The letter should summarize the meeting, the law, and make recommendations for provisions within the particular agreement and reiterate time frame to complete and sign prenuptial agreement

B. Drafting the Prenuptial Agreement

(1) Disparity or non-disparity in ages, incomes, net worth, and education must be taken into consideration by the drafter.

If the prospective spouses have unequal assets the lawyer should not play the prenuptial agreement lottery, gambling that that spouse who

[41] Edwardson v. Edwardson, 798 S.W.2d 941 (Ky. 1990)

relinquishes all spousal rights in an agreement will not challenge the agreement at the time of enforcement. Rather, given the case law, a properly drafted prenuptial agreement should provide for some material or marital benefit upon death or divorce. Further, drafters of prenuptial agreements that do not provide any marital benefit should consider the *Gentry* Element 2 which requires that an agreement not be unconscionable.[42]

If the prospective spouses start on equal footing in terms of assets, each can relinquish all spousal benefits without much fear of challenge under *Gentry* so long as the prenuptial agreement is valid on its face and satisfies the basic requirements. However, although unlikely, note that the Substantive Fairness Test could allow a valid challenge if the parties could not have contemplated an increase in wealth which occurred. [43]

A lawyer representing a prospective spouse also must be cognizant of the specific facts of a particular situation. Kentucky courts have held that education, judgment, and business acumen of the challenging spouse is taken into consideration. [44] Also, the Substantive Fairness test of Gentry allows a prenuptial agreement to be considered *at the time enforcement is sought.*[45] The lawyer should evaluate any foreseeable changes in circumstances.

(2) Specific Prenuptial Agreement Provisions

With the exception of child support, child custody, and visitation,[46] the parties are free to bind themselves contractually as allowed under law. Some cases have reflected interesting provisions which are illustrative of the specific concerns of the couple. For example, in *Ford v. Blue* the court addresses a provision of the prenuptial agreement which provided for a 50% premium in the allocation of certain assets in the event the husband rather then the wife filed for divorce.[47] However, the wife was entitled to the premium increase in the event that the filing of the divorce by the wife was precipitated by infidelity on the part of the husband.[48]

In a similar manner, if a prenuptial agreement fails to consider an issue, the parties most likely will be deemed not to have contractually agreed. In *Hardesty v. Hardesty*, a prenuptial agreement failed to address the

[42] Gentry v. Gentry, 798 S.W.2d 928 (Ky. 1990)
[43] See Blue v. Blue, 60 S.W.3d 585 (Ky. App. 2001)
[44] Lawson v. Loid, 896 S.W.2d 1 (Ky. 1995)
[45] See Gentry v. Gentry, 798 S.W.2d 928 (Ky. 1990)
[46] Edwardson v. Edwardson, 798 S.W.2d 941 (Ky. 1990)
[47] Ford v. Blue, 106 S.W.3d 470 (Ky. App. 2003)
[48] Id.

relinquishment of dower and curtesy rights and the court therefore held that such rights had not been waived.[49]

The lawyer drafting the document should strive for clarity and thoroughness in the prenuptial agreement clearly defining the parameters for who gets what and when. This is especially relevant as the provisions for death and divorce are often different. For example, maintenance or alimony could be waived in its entirety or the agreement could provide that distribution be dictated by a formula clause (i.e. a lump sum amount multiplied by the length of the marriage).

Although acceptable for provisions of an agreement to be unique to the client, certain standard prenuptial agreement provisions are as follows:

(a) Relinquishment of spousal rights. This includes a general relinquishment of all spousal rights of any kind or nature, and specifically includes the right to renunciation of a will under KRS 392.080, right of a widow's exemption under KRS 391.030.

(b) Residence. A lawyer should consider the circumstances of the parties when negotiating and/or drafting this provision. Often one spouse sells a residence and both spouses live in the other spouse's pre-marital (and therefore protected under the prenuptial agreement) home. This means that one spouse could be literally homeless in the event of a death or divorce. Given the unconscionability aspects of *Gentry* Element 2 and *Gentry* Element 3 [50] in the event of death or divorce, it is prudent to provide clarity to the circumstances of the living arrangement.

(c) Medical care. A relevant issue in modern times especially in light of the seemingly astronomical cost of medical care and prescription medications.

(d) Definition of Joint Property and Separate Property. An agreement must clearly define when property (if ever) is deemed joint and the procedure for determination.

(e) Asset Clause. Both parties to the prenuptial agreement should acknowledge that a full and complete disclosure of assets was made and they reviewed the assets of one another as provided within the agreement and were fully apprised of the amount, detail, and description of the same. After reviewing the disclosure, both parties should agree within the agreement to relinquish all rights to those spousal assets.

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[49] Hardesty v. Hardesty's Ex'r, 34 S.W.2d 442 (Ky. App. 1930)
[50] See Section III of this Article

(f) Estate Planning. Both parties generally should be permitted to provide for one another in their respective estate planning documents in excess of what is provided in the prenuptial agreement.

(g) Independent Counsel. Both parties should agree that they have been represented by counsel who has explained their legal rights to them. Counsel should be specifically named within the agreement.

(h) In Terrorem Clause. Also known as an anti-fighting clause. Especially important when there is a disparity in assets. If the non-asset spouse is provided some material benefit under the agreement, then an in terrorem clause may deter litigation.

(i) Maintenance. Under Kentucky law, parties are free to negotiate maintenance.[51]

(j) Waiver of interest in retirement. Anytime there is a relinquishment of a spousal interest in a retirement plan, a waiver should be specifically included within the prenuptial agreement to address this waiver. The prospective spouses should be contractually bound to execute all documents necessary to effectuate a release of any and all spousal rights under the retirement plan.

(k) Attorney fee provision. It is in the discretion of the Court to designate payment of the attorney fees and courts will look outside the terms of the prenuptial agreement if parties have disparity in assets. [52] In other words, if the lawyer represents the client with significant assets, recognize that court could order the asset spouse to pay the attorney fees of the non-asset spouse.

(l) Choice of law. If the agreement is drafted in consideration of the law of Kentucky, the prenuptial agreement should state that Kentucky is the controlling law to be applied to the agreement.

(m) Amendment. All amendments to the prenuptial agreement must be in writing and by agreement of both parties.

(n) Substantive Fairness Test Clause. If relevant to the circumstances, and in light of the Substantive Fairness Test a lawyer could include

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[51] See Edwardson v. Edwardson, 798 S.W.2d 941 (Ky. 1990)

[52] See Lane v. Lane, 2004 WL 178374 (Ky. App. 2004) unpublished and Ford v. Blue, 106 S.W.3d 470 (Ky. App. 2003)

language that the parties recognize and contemplate an increase in the wealth of the party with greater assets.[53]

(o) Debts. The prenuptial agreement should clearly define the parties obligations concerning debt incurred during marriage.

C. Execution of Prenuptial Agreement

Many attorneys recommend execution of four originals of the prenuptial agreement (two original copies to each). In addition to signing the actual agreement, the parties also sign the asset sheets attached as exhibits indicating review and acknowledgement.

D. After Execution of Prenuptial Agreement

The lawyer should draft a detailed closing letter which should advise the client as follows:

(1) Safekeeping of Originals. The original documents should be kept in a protected location. Missing original documents could allow for a challenge based upon revocation, destruction, or abandonment.[54]

(2) Estate planning. The lawyer should clarify that all amendments to the prenuptial agreements must be in writing. In addition, all estate planning done in the future must contemplate the provisions of the prenuptial agreement. This is particularly relevant with regard to power of attorney documents which could frustrate the client's intentions with regard to estate planning if not done correctly.[55]

(3) Property Title. The lawyer should explain joint property (survivorship) vs. separate property (tenants in common) in the context of the practicality of the particular prenuptial agreement.

IX. Prenuptial Agreement Litigation

When a prenuptial agreement is challenged, the opponent of the prenuptial agreement has the burden of proving the prenuptial agreement is invalid or should be modified.[56]

Although the overwhelming majority of prenuptial agreements are upheld by Kentucky Courts,[57] an agreement is subject to the three limitations of *Gentry*.

[53] See Blue v. Blue, 60 S.W.3d 585 (Ky. App. 2001)
[54] See Truitt v. Truitt's Adm'r, 162 S.W.2d 31 (Ky. App. 1942)
[55] See Bohlinger v. O'Hara, Ruberg, Taylor, Sloan & Sergent, 2004 WL 2415071 (Ky. App. 2004)
[56] Rupley v. Rupley, 776 S.W.2d 849 (Ky. App. 1989)

And, it is well established that a prenuptial agreement is subject to review at the time that enforcement is sought.[58]

A. Attorney Malpractice

There is always a potential for an attorney malpractice claim against the lawyer/advisor to the client. This is especially so in the event that the prenuptial agreement does not withstand court challenge. Certain aspects are clearly within the realm of the responsibility of prudent counsel and include clarity in the document, independent advice, and explanation of certain basic legal principals. It is these factors which could be examined for the purpose of malpractice.

There are general guidelines for avoiding malpractice in drafting prenuptial agreements. A basic review of Kentucky caselaw reveals the following as necessary for the representation of a client in the prenuptial agreement process: engagement letter, initial letter of explanation, separate counsel, full disclosure of assets as documented by a letter in the lawyer's file, signature on asset sheet of both parties, waivers with substantial fairness language, and detailed closing letter.

Claims against an attorney for malpractice have extended to estate planning attorneys. In a recent unpublished decision, the family of a decedent brought a malpractice action against the estate planning attorney who drafted the prenuptial agreement, the will, and the power of attorney.[59] In the action against the attorney who drafted the documents, the allegation was that the power of attorney was so broadly written as to enable the spouse/wife to frustrate her husband's estate plan (leaving his estate to his children).[60] The Court found that the one-year statute of limitations began to run on the date the cause of action was, or reasonably should have been, discovered.[61] In this case, the plaintiff/children were advised by a separate attorney that the same should be investigated in excess of a year before the claim was made thereby barring the action against the attorney.[62]

B. Fraud on the Dower

If a prenuptial agreement is not challenged or if it withstands challenge, then if spousal rights were properly relinquished, fraud on the dower will not be an issue. However, in the event a prenuptial agreement is successfully

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[57] See Appendix A- Summary of Prenuptial Agreement Cases in Kentucky 2004-1929
[58] Gentry v. Gentry, 798 S.W.2d 928 (Ky. 1990); also see Blue v. Blue, 60 S.W. 3d 585 (Ky. App. 2001)
[59] Bohlinger v. O'Hara, Ruberg, Taylor, Sloan & Sergent, 2004 WL 2415071 (Ky. App. 2004)
[60] Id.
[61] Id.
[62] Id.

struck down, a claim for to recoup assets may come in the form of a fraud on the dower claim.

C. Spousal Services

In the area of probate, often a spouse seeking to challenge a prenuptial agreement asserts a claim for services. The typically claim for services demands compensation for the care of the spouse during the term of his final illness. Spouses cannot claim services, they are assumed to provide services free of charge.[63]

X. Conclusion

Parties to a marriage can enter into a written contractual agreement prior to marriage which defines certain legal marital rights. Although issues related to child support, custody, and visitation are off limits, parties are otherwise free to determine and relinquish other marital rights which would normally result from death or divorce. The agreements are subject to a three part test and may be reviewed at the time enforcement of the agreement is sought. This test is applied to each case and dependent upon the specific facts and circumstances of the parties.

[63] Bagby v. Koch, 98 S.W.3d 521 (Ky. App. 2002)

PA = prenuptial agreement
H = husband
W = wife

A SUMMARY OF PRENUPTIAL AGREEMENT CASES IN KENTUCKY 2004-1929

	Case	Upheld	Struck Down	Did not Consider/ or Mixed	Type	Holdings and Points of Interest
1)	Bohlinger v. O'Hara 2004 WL 2415071 (Ky.App. 2004) unpublished			x Did not consider	Death Legal Mal.	W and H signed PA, 7 years later H named W as attorney in fact. W used POA and transferred $160,000 to joint name Allegation against attorney for failure to properly advise H that wife could sell or gift assets which could frustrate H's estate plan Court found that SOL began to run against attorney when children knew of the incident
2)	Lane v. Lane 2004 WL 178374 (Ky. App. 2004) unpublished	x			Divorce	Disparity in assets: H made $166,000 at the time of marriage and wife made $18,000. At the time of dissolution H made $1,000,000. W argued Gentry #3 - PA became unconscionable based upon the parties changed circumstance Ct. applied Substanative Fairness Test of *Blue* 2001 to uphold agreement and deny maintenance. Court found that W had not met her burden in showing that her position suffered in such a way that was not comtemplated at the time of the marriage Court allowed attorney fees in the Cts discretion
3)	Ford v. Blue 106 S.W.3d 470 (Ky. App. 2003)			x Already upheld in 2001 decision	Divorce	Interpretation of 50% premium clause to wife if H files for divorce where W filed for divorce in FL, H then filed for divorce in KY, and FL case was dimissed Court considered disparity of finanical resources and looked passed PA to award attorney fees to wife

	Case	Upheld	Struck Down	Did not Consider/ or Mixed	Type	Holdings and Points of Interest
4)	Bagby v. Koch 98 S.W.3d 521 (Ky.App. 2002)			x	Death	Plaintiff, an attorney, did not file renunciation which complied with the statutory requirements. Ct. then did not have to address the issue of the validity of the PA Spouses cannot claim services
5)	Blue v. Blue 60 S.W.3d 585 (Ky. App. 2001)	x			Divorce	W argued unconscionability based upon signifcant increase in value of H's non-marital property - This is the third element of *Gentry* Court upheld the PA finding that no increase in H's net worth, however great, would render the agreement unconscionable absent some negative change in her financial condition Applied *Substantive Fairness Test*: A more appropriate test of the substantive fairness of a PA requires a finding that the circumstances of the of the parties at the time the marriage is dissolved are not so beyond the contemplation of the parties at the time the PA was entered into as to cause its enforcement to work an injustice W received $650,000 pursuant to agreement which compensated her based upon the length of the marriage. Wife claimed "homemaker" services increased his net worth Each had separate counsel; W's counsel drafted PA Parties had been married previously to each other and to someone else
6)	Lawson v. Loid 896 S.W.2d 1 (Ky. 1995)	x			Death	Issue: Full disclosure Wife's previous marriage and education were a factor. Signed PA on day of the wedding

	Case	Upheld	Struck Down	Did not Consider/ or Mixed	Type	Holdings and Points of Interest
7)	Edwardson v. Edwardson 798 S.W.2d 941 (Ky. 1990)	x			Divorce	A PA can determine maintenace/alimony provided there has been full disclosure and subject to scruity for unconscionability
8)	Gentry v. Gentry 798 S.W.2d 928 (Ky. 1990)	x			Divorce	Upheld PA Signed a few days before wedding Second marriage $1,500.000 in H's assets vs. 0 for W
9)	Luck v. Luck 711 S.W.2d 860 (Ky. App. 1986)		x		Death	*Gentry* element #1 (dosclosure) signed temporary agreement on day of wedding as lawyer was not available No disclosure and no consideration wife testified that she was not aware of his assets
10)	Herren v. Cochran 697 S.W.2d 149 (Ky.App. 1985)	x			Death	Court found that the PA was in fact an agreement to make a will and upheld its terms PA gave her property contingent upon length of marriage
11)	Prather v. Cox 689 S.W.2d 623, (Ky. App. 1985)			x	Death	Remanded - Ct. should have allowed jury to hear testimony concerning abandonment of PA Abandonment is a recognized defense to the enforcement of a PA in KY. Also see *Harlin.* Couple entered into a PA but all property was commingled
12)	Carter v. Carter 656 S.W.2d 257 (Ky. App. 1983)		x		Divorce	Revocation of original agreement by H was a valid revocation Parties were married 2 days after PA was signed It was undisputed by the parties that H destroyed original PA in presence of W

	Case	Upheld	Struck Down	Did not Consider/ or Mixed	Type	Holdings and Points of Interest
13)	Jackson v. Jackson 626 S.W.2d 630 (Ky. 1981)	x			Divorce	PA required H to furnish to W a "decent support" did not violate public policy
14)	Lipski v. Lipski 510 S.W.2d 6 (Ky. App. 1974)	x			Death	*Gentry* Element #1(disclosure) Signed PA within 1 month of marriage One lawyer represented both H and W W claimed that she did not read the PA, however court considered testimony that she discussed the PA terms with relatives and upheld the PA
15)	Brown v. Brown 265 S.W.2d 484 (Ky. App. 1954)	x			Death	*Gentry* Element #1 (fraud) Signed PA within 3 days of wedding Court found that the prima facie inequity of a PA nor the disparity between the allowance to the W and the means of the H is regarded as constituiting fraud
16)	Truitt v. Truitt's Adm'r 162 S.W.2d 31 (Ky. App. 1942)			x	Death	PA was not found, w denied the existence of the agreement Ct. reversed judgment of trial ct. which considered testimony of "self-serving" witness when trial ct. ruled the PA existed.
17)	Ball v. Cecil 148 S.W.2d 273 (Ky. App. 1941)			x	Death	Whether third party benef. had interest in estate of deceased because he was mentioned in PA Couple divorced before death of H.
18)	Pressman v. Pressman's Adm'r 120 S.W.2d 739 (Ky. App. 1938)			x	Death	Case involved intrepretation of clause in PA which required H to provide support for his W during her natural life. Issue was whether this in light of the contract as a whole the PA was intended after death. PA ended at death of H.

	Case	Upheld	Struck Down	Did not Consider/ or Mixed	Type	Holdings and Points of Interest
19)	Clore v. Clore 132 S.W. 2d 548 (Ky. App. 1939)			x	Death	W asserts action to cancel PA on ground that PA was produced by fraud, deceit, and under duress. W was houskeeper 42 and H was 72. W -- have an attorney and did not read the PA, no disclosure of assets. W claims she is uneducated. Issue was what SOL applied. Ct held that 5 year SOL --- began to run until W discovered fraud.
20)	Harlin v. Harlin 87 S.W. 2d 937 (Ky. App. 1935)	x			Death	H was 87, W was 54. PA was signed on date of wedding. W has $4,200 in assets H had assets of $30,000. W claimed that the provisions made for her are so wholly disproportianate to the means of her in that it raised a presumption of fraud. Disparity of the assets of the parties is not in itself fraud.
21)	Hardesty v. Hardesty's Ex'r 34 S.W. 2d 442 (Ky. App. 1930)			x	Death	The PA did not specifically addressed dower rights; therefore Ct. assumed W had not waived her right to dower.
22)	Potter's Ex'r v. Potter 29 S.W. 2d 15 (Ky. App. 1930)		X		Death	Signed PA day of wedding. W was limited in her ability to read and write, agreement was not read to her. W must have been approached of the nature and extent of her perspective H's estate and the value of the marital rights she was surrendering.
23)	Hicks v. Oaks Adm'r 24 S.W.2d 917 (Ky. App. 1930)		X		Death	Intrepretation of provision of PA which allowed each to share and share alike in net proceeds of the joint property.
24)	Glazebrook v. Glazebrook 13 S.W.2d 776 (Ky. App. 1929)			x	Death	Parties entered into an oral PA relinquishing their rights in each others estates and poviding that the W would name H as beneficiary of $1,000 life insurance policy. At death of W, H received insurance proceeds and renunced the will. Court found that although oral PA was not enforceable, the insurance proceeds (the consideration) may be recoved as an implied promise to pay.

SELECTED INCOME TAX ISSUES OF INTEREST TO ESTATE PLANNERS

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SECTION I

SELECTED INCOME TAX ISSUES OF INTEREST TO ESTATE PLANNERS

SELECTED INCOME TAX ISSUES OF INTEREST TO ESTATE PLANNERS

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I. INTRODUCTION

A. It is the author's premise that insufficient attention is paid by practitioners to income tax minimization in estate planning and the administration of trusts and estates. Income tax issues impact almost all decedents and survivors (not just those very wealthy clients with gift and estate tax problems).

B. Significant dollar savings can be achieved by taking advantage of perfectly legal and appropriate income tax planning steps. On the other hand, not taking such steps will subject the fiduciary and fiduciary's professional advisors to substantial malpractice exposure.

C. Estate planning and the administration of trusts and estates should be a team effort, and it is essential that the fiduciary obtain both accounting and legal advice in order to minimize income taxes.

II. GRATUITOUS TRANSFERS (i.e., GIFTS)

A. Introduction. Clients are routinely encouraged to make gifts. Gifts are made for a variety of reasons (for junior to have funds for college or a start in life, to allow junior to gain experience in handling investments, to minimize income taxes and transfer taxes, for asset protection planning, etc.).

B. Obvious Tax Issues. When a client makes a gift, certain income tax consequences are generally assumed to occur: (1) the donor gets no income tax deduction; (2) the donee has no taxable income; and (3) in the case of an in-kind gift, the donee will have the donor's acquisition date and cost basis, with an adjustment if gift taxes were paid.

C. Income May Result. It is possible for the donor to have income as a result of making a gift.

1. Imputed Interest Income. Gift loans (i.e., those containing a below market rate of interest) cause the lender to have imputed interest income for income tax purposes, subject to a *de minimis* rule. IRC §7872.

2. Gift of Installment Note Receivable. The transfer of an installment obligation by lifetime gift will constitute a disposition and will cause an acceleration of the deferred gain for income tax purposes. IRC §453B.

3. Assets With Debt in Excess of Basis. Where a gift is made of property subject to nonrecourse indebtedness, the donor will realize gain to the extent that indebtedness exceeds the basis of the property. Winston F. C. Guest, 77 T.C. 9 (1981). The "amount realized" is equal to the outstanding balance of the non-recourse obligation, and the fair market value of the property is irrelevant to the computation. Tufts v. Commissioner, 103 S.Ct 1826 (1983).

4. Certain Net Gifts. Where a "net gift" is made (i.e., the gift taxes on the transfer, which are the legal obligation of the donor, are instead to be paid by the donee), the donor will realize gain to the extent the gift tax paid by the donee exceeds the donor's adjusted cost basis in the property. Diedrich v. Commissioner, 643 F.2d 499 (8th Cir. 1981).

D. Computation of Basis.

1. Adjustments for Gift Tax and GST Tax Paid.

   a. The donee of property which is received in a lifetime gift transaction where no gain is recognized receives such property with a carryover of the donor's cost basis and acquisition date. IRC §1015.

   b. The basis of gifted property is increased for pre-1977 gifts by the gift tax paid. For gifts made after 1976, the basis of gifted property is increased by that portion of the gift tax paid attributable to the donor's net appreciation in the gifted assets. IRC §1015.
   Example: Assume that in 2000 the donor gives stock having a basis of $200 and a fair market value of $1,000 to child, and pays $400 of gift tax. The basis adjustment for the gift tax paid is [($1000 minus $200)/$1000] times $400, or $320. The donee's basis becomes $200 plus $320, for a total basis of $520.

   c. The basis of gifted property is increased (but not to above fair market value) by generation-skipping taxes paid. IRC §2654. This basis adjustment for GST taxes paid is applied after the basis adjustment for gift taxes paid pursuant to IRC §1015.

2. Dual Basis is Possible. For purposes of determining loss in a subsequent

sale of a gifted asset by the donee, the donee's basis cannot exceed the fair market value of the gifted property at the time of its receipt by the donee. IRC §1015. ***Example:*** Donor gives stock having a basis of $100X and a fair market value of $50X to Child. No gift tax is paid on the gift. Child has a $100X basis for gain purposes and a $50X basis for loss purposes.

3. PAL Losses Are Added to Donee's Basis. The transfer of a passive-activity asset by lifetime gift does not trigger the recognition of suspended passive activity losses. IRC §469(j)(6).

E. Conflicting Code Provisions. In the case of the gratuitous forgiveness of indebtedness, the Code contains conflicting provisions relating to whether or not the donee has received gross income. IRC §§61(a)(2) and 102(a). It has been held that the forgiveness of indebtedness which is a true gift made gratuitously and with donative intent is not included in gross income. Helvering v. American Dental, 318 U.S. 322 (1943).

III. TRANSFERS FOR VALUE (i.e., SALES)

A. Introduction. Clients often engage in sales transactions for value with family members or family-controlled entities. Sales are made for a variety of reasons (to freeze transfer tax values, to get the family business to the children and cash for retirement to the parents, etc.).

B. Obvious Tax Issues. When a client sells an asset, certain income tax consequences are generally assumed to occur: (1) the seller has either gain or a loss; (2) such gain or loss can either be treated as short-term or long-term gain or loss; and (3) well-known rules apply to transactions qualifying as a 1031 tax-free exchange or as an installment sale.

C. Some Transactions are Ignored.

1. Sales Between a Husband and a Wife. No gain or loss is recognized upon the transfer for value (i.e., the sale) by an individual to such individual's spouse. The transaction is treated as a gift, and transferee has the transferor's cost basis. IRC §1040.

2. Sales Between a Grantor and a Grantor Trust. The deemed owner (i.e., the "grantor") of a trust under the so-called "grantor trust" rules will not recognize gain or loss in a sales transaction between such grantor and grantor trust. Rev. Rul. 85-13, 1985-1 C.B. 184.

D. Gain and Loss Issues Result.

1. Ordinary Income Results if Depreciable Property is Sold. Any gain recognized by the transferor upon the sale or exchange of property between specially defined related persons will result in ordinary income (i.e., not capital gain) to the transferor if the property is depreciable property in the hands of the transferee. IRC §1239.

2. Capital Gain Results if Depletable Property is Sold. The IRS has determined that IRC §1239 does not apply to the sale of depletable property between specially defined related persons (i.e., the transferor can have capital gain). PLR 8139052 (June 30, 1981).

3. Losses are Disallowed if Sale is to a Related Party. Any loss recognized by the transferor upon the sale or exchange of property between specially defined related persons will be disallowed. However, any gain subsequently recognized by the transferee will be reduced by the amount of such previously disallowed loss. IRC §267.

4. Sale of Term Interests in Trusts. The basis of the owner of a term interest (i.e., a life estate, term of years, or remainder interest) will be considered zero if it is sold by itself, but shall be its portion of the entire adjusted outside basis of all trust interests if such sale is part of a transaction in which all interests in such trust are being sold. IRC §1001(e).

E. Unusual Timing Issues.

1. Installment Sale to Related Party. If an installment sale is made to a related party who subsequently resells such property before the original seller has been fully paid (with a 2-year cutoff for property other than marketable securities), the sale by the second party accelerates the recognition of gain to the original seller. IRC §453(e).

2. 1031 Exchange with Related Party. If a taxpayer enters into a tax-free exchange with a related party and, within two years of the last transfer which was part of the exchange, either party disposes of the property received by that party in the exchange, then the original transaction does not qualify for the non-recognition of gain or loss under IRC §1031 for either party. IRC §1031(f).

F. Who Reports the Income? Who is liable to report any income is not clear where the asset sold was owned by a life tenant and remainderman. See United States v. DeBonchamps, 278 F.2d 127 (9th Cir. 1960); Robinson v. United States, 192 F.Supp. 253 (ND Ga. 1961); Rev. Rul. 61-102, 1961-1 CB 245; Hirschmann v.

United States, 309 F.2d 104 (2nd Cir. 1962); West v. United States, 310 F.Supp. 1289 (ND Ga. 1970); Gaskill v. United States, 188 F.2d 507 (ND Tex. 1960).

IV. BASIS ADJUSTMENTS AT DEATH

A. Introduction. All assets included in a decedent's gross estate for federal estate tax purposes potentially qualify for basis adjustment, or for other special income tax-related relief, upon a decedent's death.

B. Obvious Tax Issues. When a client dies, certain income tax consequences are generally assumed to occur: (1) the decedent's assets (except IRD) are stepped up (or down) in basis to their fair market value as of date of death; and (2) the recipients of IRD ("Income in Respect of a Decedent") deduct the federal estate tax attributable to such IRD as it is collected.

C. General Rule. The basis of property acquired from a decedent generally becomes the fair market value of that property at date of death unless one of the exceptions outlined below applies. IRC §1014.

D. Property Acquired From a Decedent. Property acquired from a decedent includes virtually any property deemed owned by the decedent for estate tax purposes (i.e., included in the decedent's gross estate), including probate and non-probate property, whether or not the decedent's gross estate was large enough to require the filing of a Form 706, Federal Estate Tax Return.

1. Property in Which the Decedent Had an Interest. Any property owned by the decedent (i.e., probate property) is caught under this provision. IRC §2033.

2. Transfers With Retained Life Estate. Property given away by the decedent is nevertheless included as a part of the decedent's estate where the use of (or income from) such property was retained until the decedent's death. IRC §2036.

3. Transfers Which Take Effect at Death. Property given away by the decedent is nevertheless included as a part of the decedent's estate where the decedent retained a reversion worth more than 5% and someone else can get the property by surviving the decedent (i.e., Donor to Beneficiary for life, remainder to Donor if then living, otherwise to Beneficiary's descendants). IRC §2037.

4. Revocable Transfers. Property given away by the decedent is nevertheless included as a part of the decedent's estate where the decedent retained a

prohibited power to alter, amend, or revoke the transferred property until the decedent's death. IRC §2038.

5. Gifts Made Within Three Years of Decedent's Death. Certain property and rights no longer held by the decedent are taxed as part of the decedent's estate, including life insurance on the decedent's life where incidents of ownership were given away within three years of the decedent's death, gift taxes on gifts made within three years of the decedent's death, and property in which the decedent released an IRC §2036, 2037, or 2038 power or interest within three years of his or her death. IRC §2035.

6. Joint Interests. Some portion of property in which the decedent has an interest as a joint tenant (or tenant by the entirety) is included in the decedent's estate. IRC §2040.

7. Powers of Appointment. Property over which the decedent held too broad a power of appointment (as defined in this section) will be deemed owned by the decedent for estate tax purposes. IRC §2041.

8. QTIP Property. The assets in a QTIP marital trust established by a prior spouse of the decedent for the decedent's benefit are taxable as assets of the decedent at the decedent's death. IRC §2044.

E. Exceptions to General Basis Rules.

1. Alternate Valuation Exception. If alternate valuation has been elected under IRC §2032, the IRC §2032 value becomes the new basis. IRC §1014.

a. Alternate valuation can only be elected where the gross estate and estate tax due are both reduced as a result of the election.

b. If alternate valuation is elected, all estate assets are subjected to the alternate valuation rules (i.e., no "pick and choose").

c. Alternate valuation causes the value of the assets six months after date of death to be used, unless the assets are disposed of or distributed sooner, in which case their value at such earlier date of disposition or distribution is used.

d. Joint tenancy property is treated like probate property for alternate valuation purposes. Death (and the resulting passage of ownership to the surviving joint tenant) is not a disposition for alternate valuation purposes, but the subsequent disposition (by gift or sale) by the surviving joint tenant within the six months after the decedent's death is such a disposition. Rev. Rul. 59-213, 1959-1 CB 244.

2. Special Use Valuation Exception.

   a. If special use valuation has been elected under IRC §2032A, the §2032A value becomes the new basis. IRC §1014.

   b. If the special use property is disposed of so as to result in additional estate tax being due, making an election is necessary to increase the property's basis to its date of death value. IRC §§1016(c)(1) and 1016(c)(5)(B); Treas. Reg. §301.9100-4T(f).

   c. If no election is made, there is no adjustment to the property's basis. Conf. Rept. No. 97-215 (PL 97-34), p. 251.

   d. It should be noted that no similar provision applies to IRC §2057 qualified family-owned businesses receiving a valuation break (that provision is structured as an exclusion, rather than as a deduction), so such qualified family-owned businesses get full date of death fair market value basis.

3. Income in Respect of a Decedent ("IRD") Exception.

   a. General Rule. Items of income in respect of a decedent under IRC §691 are not entitled to stepped-up basis at the decedent's death. Examples of such items include IRA and pension plan proceeds, renewal commissions, deferred compensation, and installment notes receivable.

   b. Special Rules for Partnerships. The basis of a partnership interest acquired from a decedent is the date of death (or alternate) value, increased by the estate's (or other successor's) share of partnership liabilities and reduced by the income in respect of a decedent attributable to such partnership interest. Treas. Reg. §1.742-1.

   c. Special Rules for S Corporations. The basis of S corporation stock is date of death or alternate value, reduced by the income in respect of a decedent attributable to such stock. IRC §1367(b)(4), effective with respect to decedents dying after August 20, 1996

d. Certain Lifetime Constructive Sales. Certain lifetime constructive sales, amounting to hedging (constructive sale) transactions, such as going "short against the box" during lifetime in order to lock in profit and pull out cash, will no longer be able to be closed out income tax free after death, as the pre-death portion of the gain will be considered IRD taxable to the estate or other successor. TRA '97, §1001(d)(3), adding IRC §1259, effective (with complex exceptions and effective date rules) to constructive sales made after June 8, 1997.

4. Exception for Qualified Conservation Easement. A carryover of the decedent's income tax cost basis will occur with respect to that portion of a property which is excluded from the decedent's estate by reason of a qualified conservation easement. TRA '97, §508, amending IRC §§170,1014, 2031, and 2032A, effective for decedents dying after 1997.

5. Exception for Certain Recently Gifted Property. Property received as a gift by the decedent within one year of the decedent's death which is gifted by the decedent back to the donor will not receive an adjustment to basis by reason of the decedent's death. IRC §1014(e).

6. Exception for Previously Gifted Property.

a. Property gifted during lifetime that is nevertheless included in the decedent's estate for estate tax purposes (such as IRC §§2035, 2036, 2037, or 2038 property) will be entitled to an IRC §1014 basis adjustment by reason of the decedent's death, but the transferee must reduce such new date of death basis by any depreciation, depletion, or amortization taken by such transferee. Treas. Reg. §1.1014-3(d).

b. Conceptually difficult issues are raised when previously gifted property included in the decedent's estate (such as IRC §§2036, 2037, or 2038 property) has been sold and reinvested in something else prior to the decedent's death. For estate tax purposes, the original property is deemed included in the decedent's estate. But if it has been sold prior to the decedent/donor's death, can the donee file an amended income tax return and claim the date of death value as the adjusted basis? See Humphrey's Estate v. Commissioner, 162 F.2d 1 (5th Cir), cert. denied, 332 US817 (1947); Rev. Rul. 72-282, 1972-1 CB 306.

7. Exception for Certain Spousal Joint Tenancies.

a. The current rules relating to estate taxation of joint tenancy interests provide that one-half of a spousal joint tenancy asset is included in the deceased spouse's estate under IRC §2040, which results in the deceased spouse's one-half of the asset having its basis adjusted under IRC §1014 and the surviving spouse's one-half of the asset being left with its historic cost basis.

b. Prior to 1982, the portion of a spousal joint tenancy asset included in the deceased spouse's estate was determined with reference to the deceased spouse's relative contribution to the acquisition of the asset (the so-called "tracing of contribution" test). Accordingly, before 1982 as little as 0% or as much as 100% of a spousal joint tenancy asset might have been included in the deceased spouse's estate under IRC §2040 (and have its basis adjusted in IRC §1014).

c. The IRS has recognized that 1981 amendments to IRC §2040(b)(2) did not repeal the effective date of IRC §2040(b)(1), the net impact of which is to still apply the tracing of contribution rules to spousal joint tenancy assets acquired before 1977. <u>See</u> <u>Gallenstein v. U.S.</u>, 975 F.2d 286 (6th Cir. 1992); <u>Patten v. U.S.</u>, 116 F3d 1029 (4th Cir., 1997); <u>Anderson v. U.S.</u>, 78 AFTR 2d 96-6557 (DC MD 1996), and <u>Hahn v. U.S.</u>, 110 TC 14 (1998).

8. <u>Exception for Community Property Interests</u>.

a. The survivor's one-half interest of community property, as well as the decedent's one-half interest in such property, gets new basis (equal to the fair market value of such assets) at the decedent's death. IRC §1014(b)(6).

b. It is thus essential to ascertain whether or not the decedent and his or her spouse ever lived in one of the community property states (i.e., Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin), and if so, if community property was thereby created (and subsequently preserved) --- even if the client resided in a non-community property state at death. Additionally, Alaska has adopted an elective form of community property.

c. Some states now allow community property to be held in joint tenancy, and it is unclear whether the joint tenancy or community property rules will apply to such arrangements. <u>See Estate of</u>

Wayne-Chi Young, 110 TC No. 24, Doc. 98-14934 (1998).

F. Special Basis Transitional Dates. A number of special basis transitional dates exist to deal with changes in the law. IRC§1014(b).

1. Death After 12-31-51. IRC §1014 applies to property transferred to a revocable trust.

2. Death After 10-21-42 But Before 12-31-47. Basis of surviving spouse's share of community property was the greater of its adjusted basis or its estate tax value.

3. Death After 12-31-47. The surviving spouse's one-half share of community property assumes the same basis as the decedent's share.

4. Death Between 1-1-51 and 12-31-53. The survivor's interest in a joint and survivor annuity received a basis adjustment if the decedent's interest was includable in his/her gross estate.

5. Death After 12-31-53. All property acquired from a decedent by reason of death receives a stepped-up basis.

6. Death After 8-26-37. The decedent's stock or securities in a foreign corporation which is a foreign personal holding company receives a basis which is the lower of the fair market value at date of death or the decedent's basis.

G. Other Basis Issues.

1. Appraisal Necessity. The applicable date for determining fair market value is "as of" the decedent's date of death, unless alternate valuation date is elected under IRC §2032. The appropriate values will appear on the Form 706.

2. Where No Form 706 Required. Successors to the decedent's property are entitled to new basis even if no estate tax was due by reason of the decedent's death. The fiduciary should obtain an appraisal or other proof to support the new cost basis even if no Form 706 is required (i.e., because the decedent's gross estate totals less than the estate tax exemption-equivalent).

3. Impact on Depreciation, Depletion, etc. Be mindful of the need to recompute future depreciation, depletion, and amortization relative to

assets (or that portion of an asset) included in the decedent's gross estate for federal estate tax purposes. Such assets will get a new basis and date of acquisition after the decedent's death, which may also result in a new life and method of depreciation as to such asset (or portion of an asset). Consider electing cost depletion where appropriate.

4. Elective Partnership Basis Adjustments. A partnership (or other entity taxed as a partnership, such as an LLC) may elect to adjust the inside basis of its assets to reflect the outside basis adjustment occurring by reason of a partner's death. IRC §754.

5. Appreciated Undistributed Devises Due Decedent. The death of a beneficiary due undistributed appreciated assets as beneficiary of another estate may or may not result in such undistributed assets having their basis adjusted, depending upon which authority you believe. Compare Manufacturers Hanover Trust Company v. U.S., 410 F.2d 77 (1969) and Connecticut National Bank v. U.S., 937 F.2d 90 (1991).

6. Post-Death Capital Gains and Losses.

    a. All capital gains or losses that occur after death are long-term capital gains or losses if the property sold was included in the gross estate of the decedent, regardless of the length of the post-death holding period. IRC §1223(11).

    b. Such long-term treatment may be valuable where a gain occurs, inasmuch as long-term capital gains have historically been afforded favorable tax treatment.

    c. Such long-term treatment may be unfavorable where a loss occurs, inasmuch as long-term capital losses in excess of offsetting capital gains can only be utilized to offset ordinary income to the extent of $3,000 per year.

    d. It is common to have post-death capital losses. For example, imagine a decedent owning only a home appraised at $100,000 which is sold 1-2 months after date of death for a net of $92,000 after commissions and other selling expenses of $8,000. The $8,000 of selling expenses, which will be taken on the income tax return (after all, there is no estate tax return due to deduct such expenses on), cause an $8,000 long-term capital loss on the seller's income tax return.

7. Certain Joint Spousal Trusts.

   a. It has been suggested that husband and wife can create a single trust with their collective assets (called a "joint spousal trust"), wherein the first to die has a general power of appointment over the entire trust, with the result that all of the their collective assets will have their basis adjusted to fair market value upon the death of the first spouse to die.

   b. The IRS has ruled that this doesn't work, because of IRC §1014(e), by reason of the simultaneous passage to the decedent and return to the surviving spouse as of the decedent's death of that portion of the assets owned by the surviving spouse prior to the decedent's death. PLR 200203045 (January 5, 2001); 200210051 (December 10, 2001).

   c. It may be possible to draft the will or trust in a manner so that the property is not deemed to pass back to its original owner.

8. Impact of Distributions to Beneficiaries.

   a. Timing of Beneficiary's Tax Consequences.

      (1) Where the beneficiary has the same year end as the estate or trust, the beneficiary reports the distribution in the beneficiary's tax year in which the estate or trust deducts the distribution.

      (2) Where the beneficiary has a different year end from the estate or trust, the beneficiary reports the distribution in the estate's year which ends within the beneficiary's taxable year. IRC §§652(c) and 662(c).

      (3) In the year of a beneficiary's death, all income actually received (even if from a trust with a fiscal year ending after the date of decedent's death) is reported on the beneficiary's final Form 1040.

   b. Distributions From Simple Trusts.

      (1) A simple trust is one which is required to distribute all of its income currently, which does not make any corpus distributions during the taxable year, and which does not

have any charitable beneficiary. IRC §651.

(2) Income required to be distributed currently is taxed to beneficiaries even if not actually distributed. IRC §652(a).

(3) Income currently distributable but accumulated because of a contest re beneficiary identity is retroactively currently taxed to actual beneficiary. Higgenson v. U.S., 238 F.2d 439 (1st Cir. 1956).

(4) DNI and the various types of income received are allocated ratably among multiple beneficiaries in proportion to their respective income interest, unless otherwise specifically allocated under the terms of the trust. IRC §652(b).

(5) A simple trust will be entitled to a distribution deduction in order to avoid having the same income taxed to both the trust and its beneficiary or beneficiaries.

(6) For simple trusts the distribution deduction, for regular income tax purposes under IRC §651, is limited to the lower of:

  (a) Income (i.e., net fiduciary accounting income) required to be distributed currently, whether or not actually distributed, or

  (b) Distributable net income.

(7) The income beneficiary will benefit from any deductible principal expenses.

(8) Items which are charged to income for accounting purposes, but which are not fully deductible for income tax purposes, can cause the estate or trust which distributes all of its accounting income to have phantom income for tax purposes. Such a result may occur because of suspended passive activity losses, nondeductible investment interest, or nondeductible "miscellaneous itemized deductions".

(9) **Example:** Assume that a simple trust is to pay 1/2 of its income to Mary, 1/4 of its income to Sam, and 1/4 of its income to Bill. It has $30,000 of dividends, $40,000 of

taxable interest, \$50,000 of capital gains, and pays a trustee's fee (charged 1/2 each to principal and income) of \$20,000.

(a) Accounting income is \$60,000, which is the amount distributable to the beneficiaries. This is because the \$70,000 of dividends and interest is reduced by the \$10,000 of trustee fees charged to income. Mary will get \$30,000, Sam will get \$15,000, and Bill will get \$15,000.

(b) Taxable income of the trust, disregarding the distributions deduction and personal exemption, is \$100,000. This is because the \$30,000 of dividends, \$40,000 of taxable interest, and \$50,000 capital gains, totaling \$120,000 of income, are to be reduced by the \$20,000 trustee fees.

(c) Distributable net income is \$50,000. This is the trust's \$100,000 taxable income, disregarding the distributions deduction and personal exemption, less the \$50,000 capital gain which is not included in distributable net income.

(d) The trust will get a distributions deduction of \$50,000 (i.e., equal to the lower of its \$60,000 accounting income or \$50,000 distributable net income. The trust will thus have \$50,000 of taxable income, less the \$300 exemption to which it is entitled. The \$50,000 taxable income of the trust will be taxed at the rates then in effect pursuant to IRC §1(e).

(e) The beneficiaries will have \$50,000 of taxable income, of which Mary will have \$25,000, Sam will have \$12,500, and Bill will have \$12,500. This is because, although they got \$60,000, they are entitled (for tax purposes) to get the benefit of the \$10,000 of trustee fees charged to principal.

(f) The trustee can offset an indirect expense such as trustee fees against any category of income in this case, as there is no exempt income against which a portion must be allocated. Assuming that dividends are reduced by the trustee fees, $10,000 of dividends and $40,000 of taxable interest will be allocated 1/2 to Mary, 1/4 to Sam, and 1/4 to Bill.

c. Distributions From Complex Trusts.

(1) A complex trust is one which may accumulate income, which distributes corpus during the taxable year, or which has a charitable beneficiary. IRC §661.

(2) Complex trusts are substantially identical to simple trusts for income tax purposes, except as to distributions of amounts other than "income required to be distributed currently."

(3) For complex trusts the distributions deduction, for regular income tax purposes, under IRC §661(a) is limited to the lower of:

(a) The aggregate of: (a) income (i.e., net fiduciary accounting income) required to be distributed currently, whether or not actually distributed, and (b) other amounts paid, credited, or required to be distributed (whether out of income or principal); or

(b) Distributable net income.

(4) Where current income and principal distributions are made, the taxable portion of the distribution is allocated among the different beneficiaries under the tier system provided in IRC §661(a):

(a) First tier distributions include the amount of income required to be distributed currently. The distributees who receive such distributions are deemed to receive DNI to the extent thereof.

(b) Charitable contributions reduce DNI after first tier distributions are taken into account.

(c) Second tier distributions are all other distributions (i.e., discretionary income and principal distributions). The distributees who receive such distributions, to the extent that first tier distributions and charitable contributions have not absorbed all of the DNI, are taxed to the extent thereof.

(5) **Example:** Assume that a complex trust must pay $10,000 to John each year, and the trustee is also given the discretion to make additional distributions to John and/or Mike if deemed appropriate. It has $20,000 of dividend income and no expenses.

(a) If the trustee makes only the required $10,000 distribution to John, John will have received a $10,000 tier one distribution. John will have $10,000 of dividend income since there is $20,000 of DNI to allocate.

(b) If the trustee makes the required $10,000 distribution to John and a $10,000 discretionary distribution to Mike, John will have received a $10,000 tier one distribution and Mike will have received a $10,000 tier two distribution. Each will have $10,000 of dividend income since there is $20,000 of DNI to allocate.

(c) If the trustee distributes the required $10,000 distribution to John, a $20,000 discretionary distribution to John, and a $30,000 discretionary distribution to Mike (i.e., they each get a total of $30,000), John will have received a $10,000 tier one distribution and a $20,000 tier two distribution, and Mike will have received a $30,000 tier two distribution. John will have $14,000 of dividend income (i.e., $10,000 because of the tier one distribution, and $4,000 as his proportionate share of all tier two distributions) and Mike will have $6,000 of dividend income (as his proportionate share of all tier two distributions).

(6) The trustee of a complex trust can elect to treat distributions made within the first sixty-five (65) days of a taxable year as having been distributed in the preceding taxable year. IRC §663(b).

(7) For tax years beginning prior to 1998, income accumulated in a complex trust and distributed to a beneficiary in later years may be subject to the complex (and often changed) throwback rules on accumulation distributions. These rules eliminate most domestic trusts from being subject to the throwback rules for years beginning after 1997. IRC §§665-668. See, IRS Form 4970 and printed instructions which are used to compute the tax on accumulation distributions from trusts.

d. Distributions From Estates.

(1) Estates are generally taxed like complex trusts (but the throwback rules were never applicable to estates).

(2) Income from an estate is generally not required to be distributed currently, so all income and principal distributions are second-tier distributions.

(3) Widow's allowances paid from principal result in a distribution deduction to the estate and count as a second-tier distribution to the widow. Treas. Reg. §1.661(a)-2(e).

(4) In a much criticized decision, interim distributions from an estate were excluded from the DNI mechanism on the ground that the estate could recapture them prior to the decree of final distribution, and that they were not "properly" paid. Bohan v. United States, 456 F.2d 851, 72-1 USTC ¶9286 (8th Cir. 1972); non-acq., Rev. Rul. 72-396, 1972-2 C.B. 312.

(5) For estates of decedents dying after 8/5/97, the executor of an estate can elect to treat distributions made within the first sixty-five (65) days of a taxable year as having been distributed in the preceding taxable year. IRC §663(b).

e. Recognition of Gain Or Loss When Making Distributions.

(1) Income Taxation of Specifically Gifted Assets.

(a) No gain or loss is recognized by the estate or trust when it distributes specifically gifted property (e.g., 100 shares of AT&T stock, the family home, etc.).

(b) The estate or trust gets no distributions deduction, nor is the beneficiary deemed to receive DNI, upon distribution of specifically gifted property. IRC §663(a)(1).

(c) The distributee succeeds to the estate's or trust's income tax basis upon the distribution of specifically gifted property.

(2) Income Taxation of Non-Formula Pecuniary Gifts.

(a) A non-formula pecuniary gift is a gift of a specific amount of money (e.g., "I give $50,000 to Joe").

(b) The estate or trust gets no distribution deduction, nor is the beneficiary deemed to receive DNI, upon the distribution of a specific amount pecuniary gift (e.g., $10,000 to Sally). IRC §663(a)(1).

(c) The estate or trust does get a distribution deduction, and the beneficiary will be deemed to receive DNI, upon distribution of a specific amount payable in more than three installments under the terms of the governing instrument (e.g., $10,000 to John, which is required under the terms of the will or trust to be paid in 4 quarterly installments, the first to commence upon the grantor's death). IRC §663(a)(1).

(d) The distribution of appreciated property in satisfaction of a pecuniary gift will trigger gain or loss to the distributing estate or trust. Treas. Reg. §1.1014-4(a)(3).

Example: The decedent's will leaves $100,000 to David. The estate gives David stock worth $100,000, but having a basis of $80,000, in satisfaction of such gift. The estate will be deemed to have sold the stock to David, resulting in a $20,000 capital gain. David has no taxable income, and will have a $100,000 basis in such property.

(3) Income Taxation of Formula Pecuniary Gifts.

(a) A formula pecuniary gift is one which uses a formula to back into the amount of the gift (i.e., "I give Joe an amount equal to one-half of my federal gross estate, valued as of my date of death."). Formula pecuniary gifts are often used to determine the amount of marital deduction gift to be made.

(b) Gain or loss (unless IRC §267 prevents a loss from being recognized upon the distribution from a trust) will be recognized when a formula pecuniary gift is satisfied with property, rather than cash, based upon the fair market value of such property at the date of distribution. IRC §1.1014-4(a)(3).

(c) However, under a much criticized (and seemingly inconsistent) Subchapter J regulation, a formula pecuniary gift is not deemed to be a gift of a specific sum. Accordingly, the estate or trust making such a distribution will get a distributions deduction, and the recipient will be deemed to receive DNI. Treas. Reg. §1.663(a)-1(b).

(4) Income Taxation of Fractional Share and Residuary Gifts. A distribution made pursuant to a fractional or percentage share formula, or a distribution of the residue or a share of the residue, is not "a gift or bequest of specific property or of a specific sum of money". Treas. Regs. §1.663(a)-1(b)(2). Accordingly, such gifts will carry out the income of the estate or trust, if any, to the beneficiary.

(5) Income Taxation of In-Kind Distributions.

(a) Distributions in kind generally don't result in the recognition of gain or loss, unless the distribution is in satisfaction of a pecuniary or fixed dollar gift. Treas. Reg. §1.1014-4(a)(3). In the case of in-kind distributions where no gain or loss is recognized, the beneficiary gets the estate's or trust's income tax basis in the property so distributed and a second tier distribution takes place in an amount equal to the lesser of the property's basis or fair market value at the time of such distribution. IRC §643(e).

(b) The executor or trustee can make an irrevocable election to recognize gain or loss upon the making of a distribution in satisfaction of a fractional or percentage share formula, or a distribution of the residue or a share of the residue. If such election is made, the property will be deemed sold to the beneficiary at its fair market value on the date of its distribution, and a second tier distribution will take place equal in amount to such fair market value. IRC §643(e)(3).

(c) It is often desired to make non-pro rata distributions in kind to beneficiaries. For example, two equal beneficiaries may decide to let one take all of the AT&T stock and the other take all of the GM stock, with cash being used to equalize the distributions to the extent necessary, rather than splitting each and every asset. Such non-pro rata distributions can be taxed as constructive taxable exchanges between the two beneficiaries unless either the governing instrument (i.e., the will or trust) or applicable local law specifically allow non-pro rata distributions to be made.

(6) Distributions of Installment Obligations and IRD Items.

(a) An in-kind distribution by an estate of an installment obligation which was created prior to the decedent's death, unless the distribution is in satisfaction of a pecuniary or fixed dollar gift, will not be a disposition of such installment obligation for the purpose of acceleration of gain. IRC §453(e)(6).

(b) No such exception exists for in-kind distributions of an installment obligation created after the decedent's death, and any distribution of such an installment obligation will trigger gain.

(c) When doing estate planning for a person whose assets consist of a great deal of installment obligations receivable and IRD items, it will be desirable to avoid pecuniary formula gifts under the estate planning documents that must be funded with such items and/or to make specific gifts of such items to the desired individuals or sub-trusts.

(d) When administering an estate or trust with a highly appreciated asset which is about to be sold on an installment basis, consider first distributing the asset to the beneficiary and then letting the beneficiary enter into the installment sale. This will avoid having the gain accelerated upon the subsequent distribution of the installment obligation to the beneficiary of the estate or trust.

(e) When administering an estate or trust that has a substantial installment obligation receivable that was created after the decedent's death, it may be desirable to find some excuse to keep the estate or trust open for as long as possible to avoid having to distribute the installment note and thus accelerating the gain.

ETHICAL ISSUES UNDER THE RULES OF THE SUPREME COURT OF KENTUCKY FOR ESTATE PLANNING AND FAMILY BUSINESS SUCCESSION ADVISORS

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SECTION J

Ethical Issues Under the Rules of the Supreme Court of Kentucky for Estate Planning and Family Business Succession Advisors

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Ethical Issues Under the Rules of the Supreme Court of Kentucky for Estate Planning and Family Business Succession Advisors

by
Eric A. Manterfield

While estate and business succession planning is frequently non-adversarial and client-centered, there are numerous ways in which advisors can be confronted with ethical issues. Someone once said that you either have integrity or you don't, but we can all learn something more about the Rules that apply to ethical dilemmas!

Too many unhappy beneficiaries are seeking ways to premise malpractice actions by citing violations of the ethics Rules, particularly conflicts of interest. All estate planning advisors must be aware of the ethical constraints that apply to our work. To the extent that the advisors become more aware of the issues involved, there can be more effective loss prevention.

While the Model Rules of Professional Conduct were adopted by the American Bar Association, Kentucky has not yet adopted those Rules. The Rules of the Supreme Court of Kentucky, which govern the ethical conduct of lawyers in that Commonwealth, became effective as of January 1, 1990. A committee has been established in Kentucky to study the ABA model Rules; however, I am informed that its recommendations (let alone action on those recommendations) is still far in the future.

In 1999, the American College of Trust and Estate Counsel adopted "commentaries" on the American Bar Association's then-Model Rules of Professional Conduct, which are published as ACTEC, Commentaries on the Model Rules of Professional Responsibility, 3d Edition (March 1999), which are hereafter referred to as the "ACTEC Commentaries." Because Kentucky's Rules closely follow those then, model Rules, the ACTEC Commentaries provide useful guidance for the estate and family business succession planner.

The Reporter's Note included at the beginning of the ACTEC Commentaries recognizes both the prevalence of conflict situations in estate and family business succession planning and the absence of specific guidelines for these planners in the ethical Rules:

> "The main themes of the Commentaries are: (1) the relative freedom that lawyers and clients have to write their own charter with respect to a representation in the trusts and estates field; (2) the generally nonadversarial nature of the trusts and estates practice; (3) the utility and propriety, in this area of the law, of representing multiple parties, whose interests may differ but are not necessarily adversarial; and (4) the opportunity, with full disclosure, to moderate or eliminate entirely many problems that might otherwise arise under the MRULE. The Commentaries additionally reflect the role that the trusts and estates lawyer has traditionally played as the lawyer for members of a family. In that role a trusts and estates lawyer frequently represents the fiduciary of a trust or estate and one or more of the beneficiaries. In drafting the Commentaries we have attempted to express views that are consistent with the spirit of the MRULE as evidenced in the following passage: 'The Rules of Professional Conduct are Rules of reason. They should be interpreted with reference to the purposes of legal representation and of the law itself.'" (emphasis added)

Any examination of the ethical issues for estate planning lawyers must begin with the applicable Rules of the Supreme Court of Kentucky (SCR 3.130). While these Rules expressly apply to attorneys, it is reasonable to expect that the spirit of these standards will be applied to other professionals who assist clients with this planning.

My hope in this work is not to provide an ironclad "road map" for every situation; rather, my goal is to illustrate the Rules in several common situations, to give some thoughts on the resolution of the problems and to raise issues that are commonly ignored (perhaps in the mistaken belief that the problem will "go away" all by itself).

It is not particularly useful for a discussion of these issues to conclude with the observation that "this is an interesting problem," with no guidance on a solution!

Little can be obtained from reported case decisions in the ethics arena. Perhaps this is because violations of ethical requirements more frequently lead to malpractice actions.

Our obligations begin with the need to provide a client with "competent representation" (Rule 1.1) and to keep the client "reasonably informed" (Rule 1.3). The latter obligation frequently causes problems for those advisors who are less than diligent.

Beyond these basic requirements, however, a planner can be presented with ethical issues involving conflicts of interest, the failure to exercise independent judgment, the violation of client confidences, incomplete or inadequate representation, even potential criminal liability for bankruptcy fraud and excessive fees. Starting with some thoughts on engagement letters and client communication, I will spend most of this paper on the other issues listed.

Engagement Letters

The advisor and the client must agree on the scope of the lawyer's representation according to Rule 1.2. Should not that agreement be documented? Should you use an engagement letter?

Some advisors may find a formal engagement letter to be intrusive on the so-called "open and honest" relationship they have with their clients. Why put "the objectives of the representation" [Rule 1.2(a)] in a letter, they wonder, when both the client and the advisor know perfectly well that the client came in for estate planning services? This issue was addressed in the ACTEC Commentaries:

> "Variations in the circumstances and needs of trusts and estates clients and in the approach and practice of individual lawyers naturally result in lawyers and clients adopting very different methods of working together. The agreement between a lawyer and client regarding the scope and objectives of the representation is often best expressed formally in an engagement letter or other written communication. However, most often their agreement is implicitly reflected in the manner in which they choose to work together."

Estate planning engagement letters. I recommend that all estate planning advisors consider the use of written engagement letters, however, particularly regarding the representation of a married couple. As will be discussed later in this material, it is frequently helpful if the advisor notifies the clients at the beginning of the representation that there can be no confidences in the representation of a husband and wife. This engagement letter can also set forth the method of your compensation, the procedure for billing, the termination of the relationship and dispute resolution.

Rule 1.5(b) provides as follows:

> "When the lawyer has not regularly represented the client, the basis or rate of the fee should be communicated to the client, preferably in writing, before or within a reasonable time after commencing the representation." (emphasis added)

Comment [1] to Rule 1.5 includes this statement: "A written statement concerning the fees reduces the possibility of misunderstanding."

A form of engagement letter for estate planning services is attached at the end of this material.

Family business succession planning engagement letters. These issues may become even more critical if you represent a family business and its multiple owners who come to you for family business succession planning advice.

Potential conflicts of interest among the owners of the business should be acknowledged. A written engagement letter can also set forth the method of your compensation, whether the fees are to be paid by the business or its owners, the procedure for billing, the termination of the relationship and dispute resolution.

A form of engagement letter for family business succession planning is also attached at the end of this material.

Diligence and Effective Client Communication

Rule 1.3 demands that "[a] lawyer shall act with reasonable diligence and promptness in representing a client." The appearance of procrastination, as well as its reality, can be exacerbated by ineffective client communications.

Rule 1.14 requires the lawyer to "keep a client reasonably informed about the status of a matter and promptly comply with reasonable requests for information." The failure to communicate regularly with a client may be one of the leading causes of ethical lapses and estate planning malpractice complaints, particularly with respect to the reasonableness of fees. The problem may be more acute in representations where much of the work is done outside of the eyes of the client.

Examples include estate work, where the personal representative and beneficiaries are often unaware (in the absence of good client communication) of the extensive work done on tax returns, inventories and the like. Other examples include will contests with corresponding time spent on legal research, depositions, document review and other matters not commonly requiring client participation, and planning for lifetime gifts with difficult valuation issues.

The more the work is done beyond the client's eyes, the more important is the requirement that we keep the client "reasonably informed." This may be more a matter of common sense than of malpractice.

Conflicts of Interest

The Rules of the Supreme Court of Kentucky present several standards addressing conflicts of interest, which are primarily found in two Rules:

1. Rule 1.7 provides the general rule that "a lawyer shall not represent a client if the representation of that client will be directly adverse to another client…."

2. Rule 1.9 provides that "a lawyer who has formerly represented a client in a matter shall not thereafter represent another person in the same or a substantially related matter in which that person's interests are materially adverse to the interests of the former client unless the former client consents after consultation."

These Rules can have significant implications for the estate planner in even the most common situation. The joint representation of multiple clients often produces a better result than would be the case had each party sought separate counsel. Economies of scale can be achieved, reducing the cost of services; the plans can be more effectively coordinated, particularly where the predominant relationship between the parties is cooperative and not adversarial.

Indeed, Rule 1.7, which provides the general rules for conflicts of interest, provides that the lawyer may not represent clients simultaneously unless "(1) the lawyer reasonably believes that the representation will not be adversely affected; and (2) the client consents after consultation. When representation of multiple clients in a single matter is undertaken, the consultation shall include explanation of the implications of the common representation and the advantages and risks involved."

The Supreme Court issued Commentary [3] to Rule 1.7 in 1989:

> "Loyalty to a client is also impaired when a lawyer cannot consider, recommend or carry out an appropriate course of action for the client because of the lawyer's other responsibilities or interests….A possible conflict does not itself preclude the representation. The critical questions are the likelihood that a conflict will eventuate and, if it does, whether it will materially interfere with the lawyer's independent professional judgment in considering alternatives or foreclose courses of action that reasonably should be pursued on behalf the client. Consideration should be given to whether the client wishes to accommodate the other interest involved."

How do these conflict of interest Rules impact lawyers in the estate and trust practice?

Representation of a married couple. While the conflicts inherent in our representation of a couple in a second marriage may be obvious, conflicts can arise even in the case of a first marriage:

1. Should jointly-held assets be divided between the spouses (so as to fund a credit trust at the death of whichever one is the first to die) or should the joint property just pass outright to the surviving spouse?

2. Should a spouse waive statutory benefits under retirement benefits, so that those dollars can pass into a QTIP trust at the death of the participant?

3. Can the advisor work with both spouses when the marital gift will be to a QTIP trust for the benefit of children of a prior marriage?

4. Can you represent both spouses when creditors of one spouse want to reach assets of the other spouse?

5. Can you advise a client of the benefits of a QTIP trust, to assure that assets will pass as "they" intend, rather than as an outright gift to the other client/spouse?

Even if you are working with a happy couple (whether in a first or subsequent marriage) whose interests are today the same, there is always the potential for conflict. Some advisors may feel that the potential for conflict is so high that one spouse must always seek other counsel. However, that solution may be too drastic and not in the best wishes of the couple you represent. Rule 1.7 permits joint representation, so long as the potential for conflict is raised and so long as the clients together consent in writing to the joint representation. This is clearly another reason to have a written engagement letter with a married couple.

Here is some language which I use in engagement letters sent to married couples:

"<u>We represent you both</u>. Our representation will be of you jointly in your estate planning. Because we represent both of you, anything disclosed by either one of

> you to me or to any personnel at [the law firm] will necessarily be open for complete disclosure to the other.
>
> I am not suggesting that this would become an issue at any point; rather, it is appropriate for us to advise all married couples of the fact that our representation of you is as a couple, simply because we are representing two people whose interests are not always exactly the same. "

This approach seems to me to be preferable to an engagement in which the advisor represents each spouse independently of the representation of the other spouse.

Even with this consent by both husband and wife to the lawyer's joint representation, conflicts can later arise.

1. <u>Where the advisor meets with only one spouse</u>. You may have a conference with only one spouse, either because the other spouse is working, is with the children, is having a bad day or what have you. Suppose that the client with whom you meet assures you that the other spouse is in full accord with the estate plan. Can the advisor simply prepare documents and have them signed on that assurance, perhaps never meeting that other spouse?

I suggest that the advisor always meet with the other spouse, to verify the statement that he or she is in "full accord with the estate plan." Go over the options and decisions that were made in the first conference. Is there understanding? Is there agreement?

If, as is frequently the case, the answers to these questions are in the affirmative, you can proceed with the execution of the documents. If, on the other hand, there is not agreement, you must decide whether joint representation can continue. It probably cannot.

2. <u>Gift splitting</u>. Suppose that both spouses have separate assets and that one client wants to make gifts to children from a prior marriage. Can the advisor recommend to the other spouse with no further discussion merely to consent to gift splitting even with the knowledge that it may impair gifts by that other spouse?

Merely asking the question leads to the obvious answer of "no." However, if you advise both spouses of the implications of gift splitting, there is no reason why you cannot continue to represent both of them, in my opinion.

3. Where the husband and wife cannot agree. While many couples agree on the basic components of an estate plan, there may easily be disagreements. Do those disagreements present the advisor with such a conflict that representation must be withdrawn? That may depend upon the nature of the disagreement.

If the husband and wife cannot agree, for example, on the people who should serve as guardian for minor children at the death of the surviving spouse, the attorney should be able to prepare wills for each spouse with conflicting wishes in that regard. Both spouses should be advised of the wishes of the other; each is advised that it is the will of the second to die which will probably be examined by the local court when determining the guardian. If they each want to proceed and sign a will on that understanding, the disagreement of the couple is not sufficient that the lawyer must withdraw, in my opinion.

If, on the other hand, the disagreement is more fundamental, the advisor can oftentimes be presented with an irreconcilable conflict. Suppose that the husband wants the marital share put into a QTIP trust and his wife is furious about that. Suppose that one spouse refuses to transfer ownership of a farm into their names as tenants in common, thereby giving up the right of survivorship. Suppose that one spouse creates a marital power of appointment trust on the assumption that the power will never be exercised, but the other spouse expresses an intent to exercise the power?

Can you then withdraw from representation of the spouse of your long time client only? May you continue to represent the long time client in the estate planning work, while sending the spouse to new counsel?

The answer to this question is more practical than ethical, in my opinion. If their differences on these issues are this fundamental, I recommend that you represent neither of the spouses on this work. It is reasonable to foresee this planning process becoming unpleasant. It might be preferable to have two new advisors separately represent the long time client and his wife on this work (with all its marital difficulties), after which the long time client should return to you for the recurring work (in other areas) you have always handled.

I suggest that, under those circumstances, it is advisable for the planner to withdraw from representation of the spouses and recommend that each seek separate counsel.

4. If the couple were later to divorce. Suppose that the advisor prepared estate planning documents for a married couple. The husband was the CEO of a local corporation which also has used the lawyer's firm for legal representation.

Some years after the preparation of the estate plan for both the husband and his wife, the husband consults the lawyer about a potential divorce from his wife. The only service performed for this wife was the preparation of a will years ago. Can the lawyer represent the husband in this divorce action?

Rule 1.9 deals with conflicts of interest with a former client, in which a lawyer who previously represented a client cannot later represent another person "in the same or a substantially related matter" where the former client's interests are "materially adverse" unless the former client gives informed consent to the representation, confirmed in writing.

Rule 1.9(c) expressly provides that "[a] lawyer who has formerly represented a client in a matter or whose present or former firm has formerly represented a client in a matter shall not thereafter: (1) use information relating to the representation to the disadvantage of the former client except as Rule 1.6 or Rule 3.3 would permit or require with respect to a client, or when the information has become generally known; or (2) reveal information relating to the representation except as Rule 1.6 or Rule 3.3 would permit or require with respect to a client."

To the extent that the pre-divorce counseling of the husband was a "substantially related matter" to the estate planning services previously provided to the wife, Rule 1.9 would apply. The lawyer presumably obtained confidential information about assets as part of the estate planning work which could be used later (she asserts) to the wife's detriment in the divorce proceeding.

Kentucky Bar Association Ethics Opinion KBA E-245 (issued in July of 1981) gave a "qualified yes" to the question "May an attorney who does an estate planning for a husband and wife, later represent either one in a subsequent divorce action?", so long as the lawyer met with the husband and wife together in connection with the prior estate planning work.

Nevertheless, could the now ex-wife (bitter over the terms of the divorce) file an ethics complaint against the lawyer on the basis of a conflict of interest? Had it not been for the lawyer's improper utilization of confidential information received from the wife in the estate planning process, she argues, a more favorable settlement could have been negotiated in the divorce property agreement.

Even if the lawyer refers the divorce work to another law firm, there may easily be liability to the extent that the lawyer counseled the husband before the divorce filing (proposed separation, probable amount of child support payments, possible terms of a division of the marital assets and the like).

Recall that Rule 1.9 permits the lawyer to consult with the husband only with the informed consent of the former client (wife). The lawyer should make full disclosure to the wife before any services are provided to the husband and obtain her consent to this new representation. The lawyer may believe that the divorce work was sent elsewhere because of this conflict of interest; however, if the lawyer merely discussed pre-divorce matters with the husband, an ethical violation may have occurred.

It is far preferable to tell both husband and wife that you are prohibited from representing either one of them in the divorce action. Do not give any legal advice to either party. Most divorce clients end up unhappy even with their own lawyer; it makes good business and ethics sense to send both away to another lawyer in another law firm.

Family estate planning. Advisors are frequently called upon to assist in estate planning for multiple generations. What conflicts may arise in that representation of both the parents and the children (and even grandchildren)?

Suppose that the parents discuss the advisability of creating generation skipping trusts for the benefit of children and grandchildren. The interests of the children may not be adequately met by a plan that gives them only an income interest. What is your obligation to the children/clients to argue against a plan desired by the parents/clients?

Suppose that the parents own a successful company, with one child active in the business and the other child not involved. The parents counsel with the advisor about a recapitalization of their S corporation, so as to create both voting and non-voting shares. The plan is to leave voting shares to the child who is active in the business and non-voting shares to the other child.

Can you continue to represent the children, recognizing that the interests of the child not active in the business may not be well served by a plan that distributes only non-voting shares?

Is the issue any different if the parents want a plan which distributes assets outright to one child and leaves the inheritance for another child in a generation skipping trust (perhaps because the latter child is irresponsible, on drugs and so forth). If you represent the parents and the child who will receive the outright distribution, is there a potential charge of undue influence with the advisor caught in the middle?

Suppose that the parents want the lawyer to prepare a pre-marital agreement for a child, even to the extent of paying the lawyer's fee. The lawyer has provided legal services to the child before and she sees no reason for a pre-marital agreement. See Rule 1.8(f) dealing with fees paid by someone other than the client.

The problem discussed earlier of conflicts with a former client may also arise in the family representation setting. Suppose that you represent the owner of a closely-held business and the son who actively works in the business. Estate plans are prepared for each client, with the father leaving control to the son and placing other assets in trust for the children who are not active in the business.

What is the consequence if the father later asks you to prepare a codicil to the will, in which the control shares are to be divided equally among all the children? The son learns of this change in his father's estate plan only after the death of his father.

Remember that you also prepared estate planning documents for the son. The son is your client or at least used to be your client. When the father approached you about a codicil, was not your new work for the father a "substantially related matter" to the estate planning that was done previously and will not your new work be "materially adverse" to the interests of the son?

The preparation of the codicil for the father should be prepared only with the consent of the son. To proceed otherwise gives the son an open invitation to assert an ethics violation.

Representing multiple owners of a business (and the business itself). While many of the same issues associated with family estate planning arise in the context of family business succession planning, the opportunities for conflicts of interest compound:

1. Where the advisor meets with only one of the business owners. The advisor may have a conference with only one business owner, typically the majority owner. Suppose that the client with whom the advisor meets assures you that the other owners of the business (the owner's children, for example) are in full accord with the business succession plan. Can you simply prepare documents and have them signed on that assurance, perhaps never meeting the other owners of the business?

Just as in the case of marital estate planning, I suggest that you always meet with the other owners, to verify the statement that "they are in full agreement with my plan." Go over the options and decisions that were made in the first conference. Is there understanding? Is there agreement?

2. Where the owners of the business do not agree. While many of the owners may agree on the basic components of a business succession plan, there may easily be disagreements.

If the owners of the business cannot agree, for example, on whether all owners must also work in the business, on who will become the next manager upon the retirement or death of the majority owner or on the pricing mechanism for a buy-sell agreement, it is unlikely that you can represent all the owners of the business. Each should have his or her own separate counsel.

If there is a fundamental disagreement over an issue of this significance, you simply cannot represent everyone. But can you continue to represent the business and the majority owner who first approached you about this work? The answer to that question may depend on the extent of the work you have done so far and the extent to which your prior work had been on behalf of the now dissenting business owners.

If there is any chance that you have, in fact, provided significant representation to those owners of the business who are now in disagreement with the majority owner's wishes, you cannot continue to represent the majority owner without the written consent of all the owners.

I suppose that there may be a disagreement over "minor" issues, which are so insignificant that you may continue to represent all the owners in an effort to reach an amicable resolution; however, great caution should be exercised whenever there is **any** disagreement among the owners. Raise the conflict of interest issue and ask them whether each is willing to have you continue to advise **everyone**.

Even if you feel the issue is not significant and the owners all want you to continue, I advise you to get their consent to your continued representation in writing. If everything blows up in the future, people have too short a memory for you to rely on their assurance that it is "not necessary" for you to get this consent in writing.

3. <u>If an owner of the business were later to leave</u>. Suppose that you prepared business succession documents for a business and its owners with their consent. You did, in fact, represent everyone. Sometime later one of the owners has a falling out and leaves the business. This departure is not pleasant and there are disagreements over issues such as the price to be paid under a buy-sell agreement or the nature and extent of any non-compete restrictions which you helped put in place.

Can you represent either side in the resolution of these issues? No. The departing owner was your client and you cannot take a position which is adverse to his or her interest without full disclosure and full written consent.

Rule 1.9 deals with conflicts of interest with a former client, in which a lawyer who previously represented a client cannot later represent another person "in the same or a substantially related matter" where the former client's interests are "materially adverse" unless the former client consents to the representation.

If you helped put the buy-sell agreement or the covenant not to compete in place, it seems clear that any disagreement over the provisions of these documents is a "substantially related matter" when you previously represented the departing owner of the business. It is not sufficient for you to protest that this departing owner was not your "real" client in the prior work. You did, in fact, provide legal services to that individual, who is entitled to the protection of the conflict of interest provisions of our ethical standards.

You cannot represent either side without everyone's written consent. Even if you refer the work to another advisor, there may easily be liability to the extent that you counseled the majority owner of the business before someone else was brought in. Did you give **any** advice which might later have been used against the interest of the dissenting owner?

Recall that Rule 1.9 permits the lawyer to consult with the majority owner only with the informed consent of the former client (departing owner), confirmed in writing. The lawyer should make full disclosure to the former client before **any** advice is given to the majority owner and obtain the written consent of the dissenting owner to this new representation of the majority owner.

Representing the elderly parent or child of an existing client. Planners are frequently asked for advice about elderly relatives. "How can we get Dad on Medicaid?" they wonder. Parents may want you to advise children about expected inheritances. The conflicts are apparent.

The existing client may bring in his or her parent to do estate planning. Sometimes, the parent is not able to come to your office, but you are assured by the existing client that he or she will tell the parent all that he or she needs to know. Indeed, the child will arrange for the execution of the documents without it being necessary for you ever to meet the "client."

Suppose you represent the parent of a child who is about to receive a distribution from a trust established by another relative. Your client wants you to advise the child to take the inheritance and put it into an irrevocable trust for the child's benefit (perhaps revocable only with the consent of the parent, your existing client).

Can you represent both the existing client and the relative, giving independent advice to each? Before you take on the representation of this elderly parent or this child of an existing client, Rule 1.7 requires you to determine that the new representation will not be "materially limited" by your responsibilities to the existing client.

The Rule goes on to require you to consult with both clients (you must meet with the elderly parent and with the child) to tell them of the possibility of a conflict. You must inform each client of the implications of the common representation and the risks and advantages involved. Both clients must give informed consent, confirmed in writing.

Where applicable, Rule 2.2 may also be involved in multiple, generational representation of this sort, particularly where "the lawyer reasonably believes that the matter can be resolved on terms compatible with the clients' best interests, that each client will be able to make adequately informed decisions in the matter and that there is little risk of material prejudice to the interests of any of the clients if the contemplated resolution is unsuccessful...."

Written consents from both clients. If Rule 2.2 is applicable (the lawyer is serving as an intermediary), you must consult with both clients, advising them of the implications of the joint representation, the advantages and risks involved, and the effect on the attorney-client privilege. Written consents should be obtained from everyone.

A client who is disabled. If one of the parties is under an incapacity, it appears that the conflict cannot be resolved. For example, if the elderly parent is incompetent, can the child (existing client) consent on behalf of the parent on the authority of a durable power of attorney given to the child by the parent?

Perhaps, if it was an only child, there may be no other person with an interest; but what if the advisor is consulted by only one child of several and the other children are not aware of the services to be provided to the incapacitated parent? I recommend that you not accept the waiver of a conflict signed by the single child without the knowledge and consent of the other children.

In a similar fashion, the consent of a minor cannot be obtained. Even when distribution is to be made on the day the child attains the age of majority, it is difficult to imagine a scenario in which the advisor (with "consent" of the child) counsels the child -- just before his or her 18th birthday -- to put the expected inheritance into an irrevocable trust that cannot be changed by this new "client!"

How is putting the inheritance into an irrevocable trust in the best interests of the child (even though that is exactly what the parent desires)? Even if you believe that putting the inheritance in trust really is in the best interests of the child (presumably because the irresponsible child will waste the funds), the advisor should consider Rule 1.14 (Client under a disability) before advising this new client. A court-appointed guardianship may be a more appropriate remedy.

Who pays your fee? Finally, if your fees are to be paid by the existing client (the parents of the young child or the adult child of the elderly parent, for example), Rule 1.8(f) requires you to disclose this fee arrangement to the new client and to determine that this fee arrangement will not interfere with your independent judgment of what is best for the new client. The new client, of course, must then provide informed consent in writing to the fee arrangement.

The advisor must exercise great care to overcome any argument that undue influence affected your advice in these circumstances. This is an obvious problem when, at the urging of an existing client, you advise a young person to place assets in an irrevocable trust, primarily to protect the child from himself. In a similar fashion, you should be very wary when an existing client dictates the terms of his parents' wills, particularly if this new will gives to that child more than his "fair" share of the assets!

The safest avenue is to assume that full disclosure of the dual representation must be made to **both** parties and written consent must be obtained from each of them.

Multiple representation in an estate setting. It is clear that advisors are frequently presented with potential conflicts of interest when a client dies. You may represent the personal representative of the estate, the surviving spouse and, perhaps, the trustees, children or other beneficiaries of the estate.

Who is the client? Is it only the personal representative or do you also represent the beneficiaries of the estate? Kentucky Bar Association Ethics Opinion E-401 (issued in September of 1997) adopted the position taken in the ACTEC Commentaries that the lawyer who represents the fiduciary does not simultaneously represent the beneficiaries.

Rule 1.7 states that the lawyer can represent these multiple clients (fiduciary and beneficiaries), so long as the clients are advised of the implications of the common representation and the advantages and risks involved and if the clients all consent. Nevertheless, it is certainly possible that later, serious conflicts can arise during the estate administration, which will lead the lawyer to withdraw as counsel for the personal representative, the surviving spouse or both.

If, as is frequently the case, there are estate beneficiaries who are not represented, the advisors to the personal representative must be certain that those beneficiaries understand that you do not represent them. Rule 4.3 provides that:

> "In dealing on behalf of a client [the personal representative] with a person [the beneficiary] who is not represented by counsel, a lawyer shall not state or imply that the lawyer is disinterested. When the lawyer knows or reasonably should know that the unrepresented person misunderstands the lawyer's role in the matter, the lawyer shall make reasonable efforts to correct the misunderstanding."

Multiple representation in a trust setting. All these same Rules and requirements relate to the advisors who represent a trustee.

Suppose that a question arises concerning the proper interpretation of the will or trust agreement. May the lawyer petition the court for instructions on behalf of the trustee and then take a position with respect to the resolution of the ambiguity? May the lawyer for the trustee represent the spouse in the subsequent hearing and assert a position on the merits of the matter before the court?

The answer is "no." Both the trustee and the trustee's lawyer are under a fiduciary duty of impartiality towards the interests of **all** trust beneficiaries.

This position is a well settled matter of common law. This principal was expressed well in the dissenting opinion in Estate of Goulet v. Goulet, 10 Cal.4th 1074, 1086, 898 P.2d425, 432 (1995), as follows:

> "It has long been settled, not only in California but elsewhere, that a fiduciary (such as the trustee of a trust or the personal representative of a decedent's estate) administering property on behalf of multiple beneficiaries must act impartially towards all the beneficiaries and must not favor, or expend funds litigating, the interest of one beneficiary over another. The fiduciary may not take sides when a dispute arises as to the relative rights and interests of various beneficiaries, and may not work to advance or oppose the claim of any beneficiary." (emphasis added)

Other cases setting forth this Rule of law include In the Matter of the Trust for Duke, 305 N.J. Super. 408, 702 A.2d 1008 (1995); The Northern Trust Company v. Heuer, 202 Ill.App.3d 1066, 560 N.E.2d 961 (1990); In re Cudahy, 26 Wis.2d 153, 131 N.W.2d 882 (1965); and In re James Estate, 86 N.Y.S.2d 78 (Surr. Ct. 1948).

In The Northern Trust Company case, the trustee had advocated a construction of the trust that was unfavorable to a beneficiary. The court held that while it was proper for the trustee to seek the court's construction of the trust by filing the complaint for construction and in gathering and presenting the information necessary for the court to interpret the trust, it breached its duty of impartiality and exceeded its duty as trustee when it argued for an interpretation adverse to a beneficiary.

The court disallowed Northern Trust's petition for attorney fees and costs related to the inappropriate activity. The court stated that while

> "generally the costs of litigation to construe a trust in which there are adverse claims are paid by the trust estate,... where a trustee breaches its duty to administer the trust according to its terms and performs in a manner which favors one beneficiary over another, the trustee is not entitled to attorney fees and costs even though the breach is technical in nature, done in good faith and causes no harm." (emphasis added)

The court stated further that "... it is preferable that we reiterate established precedent and foster every incentive for a trustee to adhere to its well-established duty of impartiality." 560 N.E.2d at 964, 965.

If the lawyer represents **most** of the trust beneficiaries, neither the trustee nor the trustee's lawyer may take a position on the merits because, to do so, must necessarily be adverse to the interests of some beneficiaries. Even if the lawyer represents **all** of the trust beneficiaries, a resolution of the ambiguity must have an negative impact on some of the lawyer's clients. That is an impermissible conflict of interest.

<u>What if the beneficiaries agree on the resolution</u>? If all the beneficiaries consent to a proposed resolution, the lawyer may present that settlement to the court; however, great care must be exercised by the attorney who attempts to negotiate that consent, to be certain that each of the lawyer's clients understand the role that is being played.

If the trust beneficiaries cannot agree on a resolution, the trustee must present the problem to the court, have the court give notice to all the beneficiaries and then the trustee must step back and let the beneficiaries make their own arguments as to the proper interpretation of the language. If the trustee were to argue in favor of one construction, it would violate the trustee's duty of impartiality because any interpretation will necessarily have a negative impact on the interests of another beneficiary (if not, why have the interpretation issue presented to the court for resolution?).

<u>The lawyer for the trustee may not assert a position for a beneficiary</u>. Just as the trustee cannot assert a position in this action, the trustee's lawyer may not assert a position "solely" on behalf of a beneficiary. That representation conflicts with the lawyer's simultaneous

representation of the trustee on all other trust matters, when the trustee must be impartial towards the interests of all beneficiaries in **everything**.

I suppose that it is possible for the lawyer to disclose to all the parties his or her joint representation of the trustee and some of the beneficiaries and to obtain their consent; however, I believe that the trustee should obtain the consent of the **other** trust beneficiaries (who are not to be represented by the lawyer) to this joint representation. And why would those other trust beneficiaries give their consent?

It is easier for the lawyer to decide whether to represent the fiduciary **or** the beneficiary, but not both.

The Failure to Exercise Independent Judgment

Advisors can be presented with conflicts of interest, including the possible allegation that you violated your duty to exercise independent judgment, when a client asks you to serve as personal representative, to serve as trustee, to receive a gift under the will or trust agreement and so forth.

1. Gifts to the advisor. While you may prepare estate planning documents for close relatives (parents, for example) from whom you will receive benefits in the future, you cannot do so if the client is not closely related. Guidance in these situations can be found in Rule 1.8(c):

> "A lawyer shall not prepare an instrument giving the lawyer or a person related to the lawyer as parent, child, sibling, or spouse any substantial gift from a client, including a testamentary gift, except where the client is related to the donee."

Comment [2] to Rule 1.8 provides that:

> "A lawyer may accept a gift from a client, if the transaction meets general standards of fairness. For example, a simple gift such as a present given at a holiday or as a token of appreciation is permitted. If effectuation of a substantial gift requires preparing a legal instrument such as a will or conveyance, however, the client should have the detached advice that another lawyer can provide. Paragraph (c) provides an exception where the client is a relative of the donee or the gift is not substantial."

The ACTEC Commentaries provide that "a closely related person is one who would receive part or all of the client's estate if the client were to die intestate; and the substantiality of a gift is determined by reference both to the size of the client's estate and to the size of the estate of the lawyer or the lawyer's spouse or children."

The prohibition against having an unrelated client make gifts to the advisor also extends, of course, to gifts that are accomplished by use of joint ownership and beneficiary designations.

Although not required by the Rule, the mere appearance of impropriety leads me to recommend that you send a non-related client who wishes to make a substantial gift to you to a lawyer in another law firm. It is not sufficient, in my opinion, to avoid the Rule by having a partner or associate in your law firm prepare the necessary documents to effectuate the gift.

2. Selection of the advisor as fiduciary. A client can name anyone he or she chooses as a fiduciary. There is nothing in the Rules of the Supreme Court of Kentucky which prohibits the selection of the advisor as personal representative or trustee, so long as the client is properly advised, the appointment does not violate Rule 1.7 or Rule 1.8 and the appointment is not the result of undue influence or improper solicitation.

Care must be exercised, however, to be certain that your conduct (in preparing an estate plan in which you are named as a fiduciary) does not have even the appearance of impropriety.

In order to advise the client "properly," the ACTEC Commentaries suggest that (before accepting an appointment as a fiduciary) you tell the client about the duties of the fiduciary, the ability of another individual or corporate fiduciary to serve in that capacity and the comparative costs of the different alternatives (including the fees to be paid to you as the fiduciary).

If you or your firm also represents a prospective corporate fiduciary, you should disclose that representation to the client who is considering that bank as a fiduciary. Finally, you should advise the client if it is the bank's practice to employ as its counsel the attorney who wrote the will or trust agreement.

If the client, after receiving this advice, still requests that you serve as executor or other fiduciary, the client should give informed consent, confirmed in writing. I recommend that this written confirmation also address the fees which you propose to charge as a fiduciary. Will you charge you normal hourly rate or will that compensation reflect the responsibilities of a fiduciary, rather than those of an attorney?

<u>Can the lawyer serve both as fiduciary and as counsel to the fiduciary</u>? While the ACTEC Commentaries note that such joint capacities may be appropriate when there has been a long standing attorney-client relationship,

> "generally, a lawyer should serve in both capacities [both as fiduciary and as counsel to the fiduciary] only if the client insists and is fully aware of the alternatives, and the lawyer is fully competent to do so. A lawyer who is asked to serve in both capacities should inform the client fully regarding the costs of such dual service and the alternatives to it. A lawyer undertaking to serve in both capacities should attempt to ameliorate any disadvantages that may come from dual service, including the potential loss of the benefits that are obtained by having a separate fiduciary and lawyer, such as the check that a separate fiduciary might provide upon the amount of fees sought by the lawyer and vice versa."

3. <u>The document which directs the lawyer's employment as counsel</u>. May a will or trust agreement direct the employment of a particular attorney as counsel for the fiduciary? Is that direction binding on the fiduciary or may the fiduciary employ any lawyer selected by the

fiduciary?

If the direction is neither binding on the fiduciary nor a customary practice among the legal community in that marketplace, the lawyer should take steps to counter the appearance of impropriety and undue influence whenever a client mandates that provision in his or her estate planning documents.

I recommend that, if the client wants the lawyer to include such a direction in a will or trust agreement, the lawyer should advise the client that this "direction" may not be legally binding on the fiduciary, who is nevertheless free to employ as counsel any attorney of the fiduciary's selection. The lawyer should document the fact that this direction is being made at the request of the client and not at the instigation of the lawyer.

4. Charitable activities of the advisor. Suppose that the advisor is actively involved in a local charitable organization. Can the advisor recommend to clients that they make gifts to that charity? Recall that Rule 1.7(b) states that "a lawyer shall not represent a client if the representation of that client may be materially limited by ... the lawyer's own interests...."

We are obligated to give to our clients independent advice and judgment, which may be clouded if we have a personal interest in the charity. Even if you will not receive a fee from the charity for this sort of gift, your independence of judgment is clearly in question.

If the client has also had a long-standing interest in the charity, the ethical issues may be lessened. The gift is not being made solely on the recommendation of the advisor.

Kentucky Bar Association Ethics Opinion E-391 (issued in July of 1996) said that a client could consent to representation by a lawyer who served on the charity's planned giving committee so long as the attorney is able "to reasonably conclude that the representation will not be adversely affected by the relationship with the charity...."

However, great care must still be exercised when both the client and the lawyer have an interest in the same charity and choices to be made by the client conflict with the wishes of the charity. For example, if the client is creating a charitable remainder trust, the client may retain the power to change the charitable beneficiary by the client's will, an action which the charity would discourage. If the lawyer fails to advise the client of this power to change the charity because of the lawyer's loyalty to the charity, an ethical violation has occurred.

If the client has no demonstrated interest in the charity and the gift is being made on the basis of the advisor's recommendation, it is likely than an ethical violation has occurred.

5. Other financial activities of the advisor. What ethical issues are presented by the advisor who also is a financial planner or sells insurance or mutual funds? Are these problems eliminated merely because those ancillary activities are carried on by a separate legal entity?

It seems clear that these other activities (or even of another organization in which the advisor has an ownership or other financial interest) present issues of self-dealing and lack of independent professional judgment regarding which course of action is in the best interests of the client. These issues cannot be ameliorated just by having the other activities carried on by a separate entity controlled by the planner.

RULE 1.8(a) applies to these transactions, and states that

> "A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to a client unless:
>
> (1) the transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing in a manner that can be reasonably understood by the client;
>
> (2) the client is given a reasonable opportunity to seek the advice of independent counsel in the transaction; and
>
> (3) the client consents in writing thereto."

It is irrelevant that the commission paid the advisor is the same as would have been paid by the client had the transaction been concluded with another provider of the product or service. An ethics violation can result even if there is no financial harm to the client. Full disclosure to the client, advice to seek independent counsel on this issue and the written consent of the client must all be obtained.

Kentucky Bar Association Ethics Opinion E-376 (issued in March of 1995) expressly answered "no" to this question: "May I sell insurance to a client, and receive a commission for it, when the sale of insurance is related to my representation of the client, and the legal representation involves estate and employee benefit planning?"

6. Clients who are referred to the advisor. Many advisors obtain new clients as a result of referrals from attorneys, trust departments, accountants, life insurance professionals and so forth. Those referral sources obviously hope (expect?) that the estate plan resulting from this relationship will result in the client's use of services or products provided by the referral sources. Is the use of those services an ethics violation?

You should advise the client of the ongoing relationship with the referral source and should affirm your primary obligation to the client.

Recall the general obligation to provide clients with advise which is solely in the client's best interests. Surely, it is frequently in the best interests of clients that the estate plan utilize the services of these outside professionals, particularly when the client has had a long-standing relationship with the referral source and the service provided is comparable in cost and quality to that provided by others.

The advisor can be presented with a dilemma, however, if he or she concludes that the best interests of the client will be served by doing business with someone other than the referral source. Suppose a bank trust officer refers a client to you and you are well aware that this trust department charges very high fees. What should the lawyer do?

Be certain that you are comparing "apples to apples" when evaluating the product or services provided by the referral source. Is the product or service provided by a competitor really comparable? Are the higher trust fees fully justified by higher levels of service or investment results?

The first obligation is to the client. If the competing services or products are truly comparable, can the referral source meet the terms and conditions of the competing service provider? The advisor should, after discussing the matter with the client, consult with the referral source and begin the conversation by confirming the advisor's obligation to the client.

Without disclosing client confidences, it may be possible for you to obtain from the referral source better terms and conditions, such that use of the original referral source's products or services is, in fact, in the best interests of the client. Full disclosure should be made to the client.

Can you send the client to the referral source, so as to get more referrals in the future, even though you believe that alternative service providers will be more in the client's best interests? The answer must be "no," of course.

<u>The Violation of Client Confidences</u>

A fundamental tenet of our professions is the requirement that we keep confidential all information acquired from or about the client relative to the representation. Rule 1.6 states that "[a] lawyer shall not reveal information relating to representation of a client unless the client consents after consultation...." This obligation of confidentiality continues even after the death of the client.

There are several implications of this general Rule.

Multiple representations. The advisor may represent several clients simultaneously, subject to the requirements of Rule 1.7 (conflicts of interest) and, where applicable, Rule 2.2 (intermediary). This sort of representation typically involves the sharing of information among the multiple clients and preserving the confidentiality of the information from others. You should advise the clients, at the beginning of the representation, of the lack of confidentiality as between themselves.

Others in your office. The advisor may share confidential client information with others in his or her office to the extent necessary for the representation. The advisor should, of course, advise those other professionals, assistants, secretaries, office staff and paralegals of the confidentiality of the information.

Confidential information from one spouse. Suppose that the advisor prepared an estate plan for a husband and wife, after advising them of conflicts inherent in this joint representation. What limitations occur when only one spouse shares confidences with the advisor?

Just as in the case of the prior discussion regarding conflicts of interest, issues of client confidentiality may arise years later when one spouse returns and requests a "confidential" codicil that makes special gifts that this client does not want the other spouse to learn about (at least not until he is dead!).

Suppose the couple had an oral agreement that assets are to be left in a certain way at the death of the surviving spouse, but now the husband comes to the advisor with the request that you prepare a codicil that will be contrary to this agreement?

Can the lawyer disclose this request to the husband's wife (the lawyer's prior client) without violating the husband's confidence? Must the lawyer disclose this request to the lawyer's prior client? Clearly, the lawyer can be put on the horns of a dilemma by one spouse who wishes the lawyer to keep confidences from the other spouse who had been (or may still be) a client.

There are at least these alternative solutions to the problem:

1. The lawyer can refuse to draft the codicil, but does that relieve the lawyer of the obligation to advise the wife of the requested change that may be adverse to his or her interests?

2. The lawyer could withdraw from the representation of the wife, make the requested change in the husband's estate plan and "hope" that the wife does not ask why the lawyer withdrew from her representation. But does the lawyer's withdrawal relieve the lawyer of the duty to advise the wife who was the lawyer's client?

3. The lawyer could withdraw from representing the spouses, but (again) does that relieve the lawyer of a duty to advise the wife of the requested change in "their" estate plan?

4. Perhaps the recommended approach is to rely on a written engagement letter, in which the lawyer advised the couple at the beginning of the representation that there can be no secrets between them in the lawyer's representation. If the lawyer had such an engagement letter, the lawyer can remind the spouse who requests the change of the lawyer's obligation to advise the other spouse.

This solution puts the dilemma back on the shoulders of the client, who can then decide whether to seek another attorney. Nevertheless, even this "solution" does not necessarily relieve the lawyer of any obligation that may exist to advise the other spouse of the requested change in the estate plan.

Therefore, I recommend that the advisor should stop the client before he or she discusses any matter which the client does not want shared with the other spouse. How can you stop someone from blurting out these matters? While that can oftentimes be difficult (or even impossible), there may be clues that the client is about to share a confidence with only you (the client comes alone to your office, looks embarrassed when you ask about the other spouse, starts by saying "Now, I don't want [the other spouse] to learn about this, but ...." and so forth).

If the advisor does have these clues, I suggest that you stop the client before the disclosure is made, remind him or her of your prior (hopefully written) agreement that there can be no confidences between the spouses in the representation and advise the client that anything he or she is about to tell you must be disclosed to the other spouse.

Again, this approach puts the dilemma back on the client, who can then decide whether to proceed with the advisor (knowing that you must advise the other spouse) or to seek other counsel.

<u>The client who later becomes incapacitated.</u> Suppose that, after representing a client in an estate planning matter, the advisor becomes aware that the client is "slipping." This growing inability to manage his or her own affairs may be the result of medical problems, alcohol or drug abuse, dependency on prescription medicines or even the undue influence of others. The advisor might learn, for example, that someone is "abusing" a durable power of attorney the lawyer drafted years ago.

Some guidance can be found in Rule 1.14, which provides that:

> "(a) When a client's capacity to make adequately considered decisions in connection with the representation is impaired, whether because of [minority] age, mental disability or for some other reason, the lawyer shall, as far as reasonably possible, maintain a normal client-lawyer relationship with the client.
>
> (b) A lawyer may seek the appointment of a guardian or take other protective action with respect to a client, only when the lawyer reasonably believes that the client cannot adequately act in the client's own interest."

Nevertheless, the advisor can be placed in a difficult decision when he or she learns (or even observes) that a long-standing client needs some help. Unfortunately, Rule 1.14 does not answer every situation.

The advisor may observe, for example, that the client needs assistance in some situations, but not in others. The client has "good days and bad days." The client may be quite capable of handling day-to-day activities, but may need help with major transactions or decisions.

The ACTEC Comment to this Rule concludes with the obvious (but not helpful) note that "the lawyer's position in such cases is an unavoidably difficult one."

What obligation does the advisor have to step forward and to take actions to protect the client? Can or should the advisor consult with the family or the physician of the client without the consent of the client? What if the client is, in the advisor's opinion, incapable of giving that consent?

Do the advisor's answers to these questions change if the reason for your concern is merely the fact that the client came to the advisor with a request for an unusual or controversial change in his or her estate plan? What if the client is brought to the advisor's office by his housekeeper and the client requests a change in the estate plan so as to leave all his assets to her?

The advisor suspects undue influence, but the client (without the housekeeper present) assures you that this is exactly what he wants to do. Does your disclosure to family or physician of the requested change in the estate plan violate your duty of confidentiality to the client?

While Rule 1.6 (Confidentiality of Information) authorizes the advisor to disclose information which is "impliedly authorized in order to carry out the representation," I doubt whether the advisor can rely on that Rule when disclosing client confidences, merely because you feel that the client wants to do something that "just isn't right."

One strategy is to suggest to the client, who wants to create a controversial change in his or her estate plan, that to do so will undoubtedly result in a will contest at death. In order to prepare for this eventuality, you advise the client, a contemporaneous evaluation by the client's physician would be helpful.

If the physician reports, after examination, that the client lacks testamentary capacity, the new will cannot be prepared, of course. But what are the advisor's obligations if the physician is not willing to make such an unequivocal statement? That is when the estate planner decides whether to be merely a scrivener (who merely writes out the client's direction) or to be a counselor in its finest sense (who strongly advises the client against a proposed course of action that, after many years representing the client, the lawyer knows is simply wrong).

Look, for example, at Rule 2.1, which provides that:

> "In representing a client, a lawyer shall exercise independent professional judgment and render candid advice. In rendering advice, a lawyer may refer not only to law but to other considerations such as moral, economic, social and political factors, that may be relevant to the client's situation."

Incomplete or Inadequate Representation. Both the competence of the lawyer and the adequacy of his or her representation are addressed by the Rules of Professional Conduct.

Rule 1.1 states that "[a] lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation." Rule 5.3 extends this same obligation to others in the lawyer's office.

Rule 1.2 provides that "a lawyer shall abide by a client's decisions concerning the objectives of the representation...." That is, the attorney and client can and must define the scope of the representation.

Most clients seek assistance in the preparation of a "short, simple will." No client comes in with the request that the advisors prepare "a really complicated estate plan!" Nevertheless, many clients today need more than a short, simple will. There may be short wills and there may be simple advisors, but there rarely is a short, simple will that is adequate for a client with substantial assets.

There are several problems involved:

1. What if the family business owner never gets around to a decision and then dies?

2. Does the advisor have the technical competence required by the client?

3. Does the advisor ask the "right" questions of the client, so that all the required information is disclosed? Do you have documentation of this?

4. Will the client be willing to follow through on your advice regarding the steps required to implement the estate plan? <u>and</u>

5. Is the estate plan that results from the representation appropriate for the client under all the circumstances which should have been known?

<u>Unwillingness of a family business owner to make a decision</u>. One of the hardest decisions we ask our clients to make concerns future management of the family business. Who will take over when our client retires, becomes disabled or dies?

Many clients have no intention of retiring and cannot face realistically the possibility of their ultimate death. We expect clients to make very difficult, emotional decisions, yet we are surprised when we meet resistance.

If you have a long-standing business client, for whom you have done many transactions, it is critically important that you urge this client to engage in succession planning. Most family businesses fail to make it to the second (let alone third) generation primarily due to a lack of planning.

To the extent your client is unwilling to make these hard choices, you should emphasize the risks associated with his failure to act. What will happen to the business? What will happen to the family? Why should he continue to put in 70 hour work weeks when so much of what he has and will accomplish is at risk?

Ultimately, you should document your efforts to have this work done. If no action is ever taken and severe consequences result, you do not want to face the unhappy family members who survive with no evidence of your efforts to have "the old man" take action.

Inadequate information from the client. One of an advisor's greatest challenges is to obtain accurate and complete information from clients. Some people are uncomfortable discussing estate planning matters and provide information only in response to direct, specific questions. They do not openly speak of their daughter's disability, so the advisor did not recommend a trust for her benefit in the will, for example.

It is gratifying to read in the ACTEC Commentaries that "in the ordinary case, a lawyer may reasonably rely upon a client's statement of facts." The Commentaries go on to provide, however, that the facts should be verified if the client appears to be uncertain or if there are "other circumstances" that raise doubts about the accuracy of the facts.

Questions the advisor should have asked. Occasionally, we create our own problems. The advisor did not ask how their assets are titled, for example, so you did not learn that all the property was jointly held until one spouse died and nothing went into the credit trust.

Incomplete implementation of the plan. Sometimes, the client is not willing to pay for the advisor to implement the plan. You advise the client to change beneficiary designations, to put assets into a revocable trust to avoid probate and to assign group life insurance to an irrevocable trust.

Who is responsible for the implementation of the plan? Can the advisor document that it was the client's (and not the advisor's) job to carry out these critical activities? Will the client follow through on your instructions? Can you later document the fact that the client was told what to do?

Co-counsel or other consulting arrangements. In a world of increasingly complex laws, it is difficult for the estate planner to stay "current" in every area. Inadequate estate plans may constitute not only malpractice, but also ethical violations. Jeff Pennell's 1991 paper entitled "Professional Responsibility: Reforms are Needed to Accommodate Personal Family Counseling," (25 Miami Institute on Estate Planning, 18-1) includes this statement:

> "Probably the most important act a 'general practitioner' can perform these days to protect against malpractice liability and the related ethical violation is to establish a good referral network to bring into a situation experts in areas in which the referring attorney is deficient."

The ACTEC Commentaries to Rule 1.1 call upon the lawyer's "additional research and study" as the first way to meet a client's needs. The Commentaries go on to provide that "the needs of the client may also be met by involving another lawyer or other professional who possesses the requisite degree of skill or knowledge. * * * The lawyer should be candid with the client regarding the lawyer's level of competence and need for additional research and preparation...."

Different types of consulting arrangements. The lawyer can call in another attorney on a consulting basis in at least two different ways:

1. The lawyer can employ another attorney to assist on an "as needed" basis on different estate planning matters, usually to review draft documents, to discuss planning

alternatives and the like for a variety of different clients. The lawyer's clients may not even be aware that these consultations occur. The consulting attorney's fees are paid directly by the lawyer; or

2. The lawyer can employ another attorney to assist a particular client on the development, drafting and even implementation of the estate plan. The client approves of this co-counsel arrangement and usually pays all the fees directly.

Written engagement letter. When an outside attorney is involved in the representation (in either approach identified above), there should be a written engagement letter between the lawyers, in which certain issues must be addressed:

1. What may the referring lawyer disclose to the other lawyer without the consent of the client?

2. Who will communicate with the client, so as to keep the client "reasonably informed" under Rule 1.4?

3. Who will be responsible for the due diligence requirement of Rule 1.3, so as to assure that the representation is proceeding properly?

4. Who will determine the amount of fees to be paid by the client and who suffers the loss if the client does not pay?

5. Does the consulting lawyer separately bill the client for services or is the statement sent to the original lawyer or is there one combined bill sent to the client, with the resulting fee shared by the co-counsel? Note Rule 1.5(e) concerning a division of fees between lawyers who are not in the same firm.

6. Who is responsible for "mistakes," such as inaccurate or incomplete information provided to the new lawyer or malpractice by the new lawyer?

7. The scope of the representation provided by the new lawyer should be set forth, including a discussion concerning who will continue to represent the client in the future on estate planning and other matters ("don't steal my client!").

A Trap for the Unwary: Criminal Liability for Advising Clients on Lifetime Gifts

Suppose a new client seeks your advice in connection with a lifetime gift program. This client has children and grandchildren and wants to transfer to them ownership interests in his closely held business. General estate planning, to dispose at death of the rest of the business, may also be involved. He mentions in passing that he has just been named a defendant in a big lawsuit, but that another law firm is handling that matter.

You advise the client on the creation of irrevocable trusts for the benefit of grandchildren, of outright gifts to the children and valuation issues for gift tax purposes. Following your advice, the client makes gifts to the children and to the trusts for the grandchildren.

<u>What is the consequence if this client later declares bankruptcy</u>? The lawsuit he mentioned casually resulted in a huge judgment against the client and he sought bankruptcy protection. Is there a problem because you advised the client on ways he could give away his assets?

Be aware of 18 U.S.C. Section 152:

"A person who --

* * *

> (7) in a personal capacity or as an <u>agent</u> or officer <u>of any person</u> or corporation, in contemplation of a case under title 11 by or against the person or any other person or corporation, or with intent to defeat the provisions of title 11, <u>knowingly and fraudulently transfers or conceals any of his property</u> or the property of such other person or corporation; ... shall be fined not more than $5,000, imprisoned not more than 5 years, or both." (emphasis added)

And beware of 18 U.S.C. Section 371:

> "If two or more persons conspire either to commit any offense against the United States, or to defraud the United States, or any agency thereof in any manner or for any purpose, and one or more of such persons do any act to effect the object of the conspiracy, each shall be fined not more than $10,000 or imprisoned not more than five years, or both ...."

But you just advised on gifts! How, if at all, do these criminal provisions apply to you when you advise the client on the transfer of assets? Did the advisor assist in the commission of bankruptcy fraud by the client?

It was the client, and not the advisor, who may have had the criminal intent of trying to hide assets from creditors. Nevertheless, it was the advisor who told the client how to commit what later became bankruptcy fraud. That is, the client could not have made the fraudulent transfers without your assistance.

Was there a conspiracy which will cause problems for the advisor under Section 371? Was the advisor an agent of the client which will cause problems under Section 152? Who needs these problems?

Some bankruptcy lawyers believe that the U.S. Department of Justice and local prosecutors may actively target estate planners for fraud actions. Some people believe that it is politically useful if a prosecutor has a few lawyers' "scalps" hanging from his or her belt!

Exercise great care with new clients who want to make gifts. Although I am not a bankruptcy attorney, the possibility of a problem here came as a surprise to me. **If the client mentions a possible large creditor, the estate planner must be very careful of the bankruptcy issues.** If the advisor should have asked about creditors and other liabilities, but simply failed to do so, there may be problems later when and if the client files bankruptcy.

There may be a simple rule. Always inquire about the existence of creditors, pending lawsuits, contingent liabilities and the like. **Document your inquiry!** If there are substantial creditors (even contingent), the estate planner should not in any way advise the client on lifetime gifts. To do otherwise may leave the advisor open to a charge that you aided the client in the commission of bankruptcy fraud.

The problem may only arise if there are existing creditors of the client. Just because a physician believes that some patient may, in the indefinite future, bring a malpractice action, there is no current creditor whose interests should be considered before a gift program is initiated. Once this vague uneasiness becomes even a contingent liability (long before a lawsuit is filed against your client by a creditor) the estate planner should not advise the physician to begin or to carry on a lifetime gift program.

The Reasonableness of Estate Planning Fees

While many attorneys charge for estate planning matters on an hourly basis, Rule 1.5(a) authorizes you to consider other factors:

> "(1) the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly;
>
> (2) the likelihood that the acceptance of the particular employment will preclude other employment by the lawyer;
>
> (3) the fee customarily charged in the locality for similar legal services;
>
> (4) the amount involved and the results obtained;
>
> (5) the time limitations imposed by the client or by the circumstances;
>
> (6) the nature and length of the professional relationship with the client;
>
> (7) the experience, reputation, and ability of the lawyer or lawyers performing the services; and
>
> (8) whether the fee is fixed or contingent."

The lawyer should advise the client at the beginning of the representation of the method of fee calculation, including whether the client will be charged for extra services, such as copying, postage, travel and the time of secretaries and other personnel.

Is the fee based on hourly charges? Is it a flat fee, for the preparation of papers to create a new limited liability company or a family limited partnership, for example?

Many lawyers will give to their clients an estimate of the fees to be charged, typically within a range.

What if the fees exceed the lawyer's estimate? The actual work required may cause the lawyer to exceed the estimated fee, perhaps because of later changes requested by the client, because the problems presented by the client were more complex than originally thought or for any other reason.

Comment [1] to Rule 1.5 includes this statement: "When developments occur during the representation that render an earlier estimate substantially inaccurate, a revised estimate should be provided to the client."

I recommend that the lawyer tell the client that the initial estimate must be revised before the extra time is spent on the representation.

It is far better, in my opinion, for the lawyer to have this conversation with the client before the time is put in; the alternative is to spend the time and then to explain, after the fact, why the client should pay more than the initial estimate.

What if the client asserts later that this extra work should not have been done, that there were other alternatives the client wanted to pursue (had he known that the initial estimate was not accurate) and so forth? Have that billing conversation with the client before you put in time that may later have to be written off when confronted with an angry client.

Fees paid by the client's employer. What considerations are presented when a fee is to be paid by a business of which the client is an officer, director, employee or owner (or all of the above)?

RULE 1.8(f) provides that:

> "A lawyer shall not accept compensation for representing a client from one other than the client unless:
>
> (1) such compensation is in accordance with. an agreement between the client and the third party or the client consents after consultation;
>
> (2) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and information relating to representation of a client is protected as required by Rule 1.6 (client confidentiality)."
>
> (3)

I suggest that the advisor address several issues before agreeing that the fee can be paid by the client's business:

1. If the client is not the sole owner of the business, must the other owners be advised that the entity's funds are being used to pay for one owner's personal estate planning?

2. If the business entity will benefit from your representation (business succession planning), should the engagement be with the entity and not with the individual client? Should not all the owners then be involved in the planning?

3. What conflicts might arise between your work for one client, your work for the entity and your work for the other owners of the entity?

Consideration should also be given to Rule 1.13(e), which provides that:

> "A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of Rule 1.7. If the organization's consent to the dual representation is required by Rule 1.7, the consent shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders."

Rebates, discounts, commissions and referral fees. A lawyer's acceptance of rebates, discounts, commissions or referral fees may involve an improper conflict of interest in violation of Rule 1.7 and may violate Rule 5.4's prohibition against sharing legal fees with non-lawyers.

Even with full disclosure to the client, such an arrangement "involves too great a risk of overreaching by the lawyer and the potential for actual or apparent abuse," according to the ACTEC Commentaries.

Conclusion

The ethical issues presented to the professionals who are engaged in estate and family business succession planning are ever present. Just being aware of the potential problems may be a step in the right direction. Ignoring these problems will not make them go away.

Eric A. Manterfield

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Sample estate planning engagement letter

__________, 2005

xxxxxxxxxxxxxxx
xxxxxxxxxxxxxxx
xxxxxxxxxxxxxxx

Dear xxxxxxxxxxxxx:

I enjoyed having the opportunity to meet with you to discuss your estate plan. I will have drafts to you by _____________ of a new will, a revocable trust agreement, an irrevocable life insurance trust agreement, a living will, a health care power of attorney and a general power of attorney. These are the documents which will carry out the plan you decided upon at our meeting.

[Give overview of the plan, decisions made by the client and any further information/decisions needed]

Terms of our engagement. Whenever we begin work with a new client, __________________ requires an engagement letter and a retainer against future billings. I think that it is important that we get down in writing a common understanding of our relationship. If my understanding is correct, I ask that you indicate your approval by signing and returning the extra copy of this letter which is enclosed.

__________________________ is very pleased to have the opportunity to assist you and your family. Our firm is committed to providing legal services in an effective and economical manner.

We represent you both. Our representation will be of you jointly in your estate planning. Because we represent both of you, anything disclosed by either one of you to me or to any personnel at ________________ will necessarily be open for complete disclosure to the other.

I am not suggesting that this would become an issue at any point; rather, it is appropriate for us to advise all married couples of the fact that our representation of you is as a couple, simply because we are representing two people whose interests are not always exactly the same.

Fees are based upon the work performed. Our fees for legal services will be billed on an hourly basis according to the billing rates charged by each lawyer or paralegal of our firm, which currently range from $_____ an hour for paralegals to $_____ an hour for senior partners.

My personal billing rate is currently $_____ an hour. I mention the billing rates for associates and paralegals because it might be more economical to have certain work performed by those people. These billing rates are subject to adjustment without notice from time to time by the firm.

In certain instances, other factors may be taken into consideration in determining our fees, including the responsibility and liability assumed, the novelty and difficulty of the legal problem involved, whether the firm is requested to issue its formal legal opinion associated with some facet of its representation, the benefit resulting to the client and any unforeseen circumstances arising in the course of our representation.

Invoices. We will provide invoices on a monthly basis. The invoices will describe our services and itemize our expenses in accordance with our standard firm policies. These expenses include such items as photocopying, long-distance telephone charges, facsimile charges, travel and related expenses, computerized legal research, postage and delivery or courier services.

Retainer. Our firm's policy is to require a retainer to be paid before we provide any legal services to new clients. **For this particular matter, _______________will require a $__________retainer from you before we proceed with any legal work on your behalf.** We will charge our initial fees and expenses against this retainer and credit them on our invoices.

The retainer is not an estimate of the total fees to be incurred or expenses advanced, of course, but is a prepayment of the initial fees to be incurred by you. Once the retainer amount is fully credited towards fees incurred and expenses advanced, it is essential to our representation that you remain current in the payment of all invoices for fees and expenses. We reserve the right to require the payment of subsequent retainers after the initial retainer is depleted.

Prompt payment. Payment relating to all invoices will be due within thirty days after the invoices are mailed. Subject to any limitations imposed by the Indiana Code of Professional Responsibility, we reserve the right to discontinue work on any aspect of this representation in the event that any invoice is not paid within thirty days after the invoice is mailed.

If we are required to resort to collection proceedings to recover any amounts from you, we will also be entitled to recover, of course, all costs incurred in those collections proceedings, including reasonable attorney fees incurred either by us or by separate counsel. By signing and returning the additional copy of this letter, you agree that any collection proceedings shall be brought in the Superior or Circuit Court of ___________County, Indiana, and you consent to the jurisdiction of that court.

Termination by either party. You have the right at any time to terminate our representation upon written notice. That termination will not relieve you, of course, of the obligation to pay for all services rendered before the termination.

We reserve the right to withdraw from this representation if, among other things, you fail to honor the terms of this engagement letter, you fail to cooperate or follow our advice on a material matter, or any fact or circumstance which would, in our view, render our continuing representation unlawful or unethical.

If we elect to withdraw from your representation, you agree to take all steps necessary to free us of any obligation to perform further and you agree to pay us for all services provided before the withdrawal.

Conclusion. If the foregoing terms and conditions accurately summarize and confirm the understanding of our new attorney-client relationship, please indicate your approval and acceptance by dating, signing and returning the extra copy of this letter which is enclosed. Your check for the amount of the retainer should also be returned with your signed copy of this engagement letter. An additional copy of this letter is enclosed for your records.

Once again, we appreciate this opportunity to serve you and your family. Should you have any questions or concerns with regard to the matters discussed in this letter, please do not hesitate to contact me. We look forward to working with you.

Very truly yours,

Agreed to and accepted this _______ day of ___________, 2005.

______________________________	______________________________
husband	wife

Sample family business succession planning engagement letter

___________, 2005

Owners of __[name of business]_____________.
[address]

PERSONAL & CONFIDENTIAL

Dear _______________:

You have asked _____[name of law firm]_______to perform certain services for you relating to your proposed business succession planning. This work may include the creation of a new buy-sell agreement among the owners of the business and other matters which may have an impact on all the business owners.

We are pleased to assist you with this work; however, it is in your best interests (and our own ethical obligation to each of you requires) that you fully understand the considerations involved in a "dual representation" of the business and its owners and of the owners with respect to each other.

The different owners may have differing (and sometimes conflicting) interests and objectives regarding business and personal planning matters. For example, you each may have different views on how to value the business and any ownership interest upon the death or retirement of an owner. There may be a conflict in whether the selling owner of the business should be subject to a covenant not to compete. There may be a conflict in how an installment payment is secured. These are just a few examples, of course; every situation is unique.

If you each had a separate lawyer, you would each have an "advocate" for your individual position and you would each receive totally independent advice. Information given to your own lawyer is confidential and could not be obtained by your fellow family business owners without your consent.

That may not be the case here (where we are advising all the business owners), but the opportunity for conflict does exist. We cannot be advocates for one of you against the other. Information that any of you gives us relating to your thoughts and special needs cannot be kept from the other owners of the business.

If you ask us to continue to serve you jointly and the business, as well, our effort will be to assist in developing a coordinated overall business succession plan and to encourage the resolution of differing interests in an equitable manner and in the best interests of your mutual business affairs. We will attempt to represent the business without a bias in favor of any of you.

In the event of an irreconcilable conflict in the future, we reserve the right to continue to represent the business and __[majority owner]______, if they wish us to do so, and we will decline thereafter to represent other owners.

If at any time any one of you wishes to have the advice of separate counsel, you are completely free to do so. We hope that this information will assist you in using our services effectively.

If you each agree with our representation under these circumstances, please read the following statement and, if you are in agreement with it, sign and return the extra copy of this letter which is enclosed.

Again, we appreciate the opportunity to be of service to all of you. I look forward to a long and successful professional relationship with each of you and with [family business]___________.

Kindest personal regards,

We have each read the foregoing letter. Each of us realizes that there are areas where our interests and objectives may differ and areas of potential or actual conflict of interest between us in connection with the family business succession, buy-sell planning and related matters.

We understand that each of us may retain separate, independent counsel in connection with these matters at any time. Each of us understands and agrees that communications and information which you receive from any of us relating to these matters will be shared with the others.

We understand that, in the event of an irreconcilable conflict in the future, you reserve the right to continue to represent the business and __[majority owner]______, if they wish you to do so, and you will decline thereafter to represent other owners.

After careful consideration, each of us requests that ______[law firm]________represent us individually and the family business jointly in connection with our business succession, buy-sell planning and related matters.

________________________________ ________________________________
Owner Owner

________________________________ ________________________________
Owner Owner

________________________________, Inc.

By:
Its: